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HUD's Proposed Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005–2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac; Proposed Rule

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Part 81

[Docket No. FR–4790–P–01]

RIN 2501–AC92

HUD's Proposed Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005–2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac

AGENCY: Office of the Assistant Secretary for Housing—Federal Housing Commissioner, HUD.

ACTION: Proposed rule.

SUMMARY: Through this proposed rule, the Department of Housing and Urban Development is proposing new housing goal levels for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Government Sponsored Enterprises, or GSEs) for calendar years 2005 through 2008. The new housing goal levels are proposed in accordance with the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA) and govern the purchase by Fannie Mae and Freddie Mac of mortgages financing low- and moderate-income housing, special affordable housing, and housing in central cities, rural areas and other underserved areas.

To increase homeownership opportunities for families targeted by the three housing goals, this rule also would establish new subgoals for the GSEs' acquisitions of home purchase loans that qualify for each of the housing goals. Under the proposed rule, performance under these subgoals would be calculated as percentages of the GSEs' total acquisitions of home purchase mortgages for single-family, owner-occupied properties located in metropolitan areas meeting each of the three housing goals.

The Department also proposes to revise the existing rule to provide enhanced requirements to ensure GSE data integrity by: codifying the existing authority that authorizes HUD to independently verify the accuracy and completeness of data, information and reports provided by the GSEs; establishing certification requirements for the submission of the GSEs' Annual Housing Activities Report (AHAR) and for such other report(s), data submission(s) or information for which certification is requested in writing by HUD; codifying a process for handling errors, omissions or discrepancies in a GSE's current year-end data submissions; clarifying that HUD may exercise its goal counting authority by adjusting a GSE's housing goals performance for a current year by deducting miscredits from a previous year caused by errors, omissions or discrepancies in a GSE's prior year data submissions (including the AHAR); and clarifying that HUD may take enforcement action against the GSEs, as authorized by FHEFSSA and as implemented by HUD's regulations at 24 CFR part 81, subpart G, for the submission of non-current, inaccurate or incomplete report(s), data or information.

In addition, HUD is proposing in this rulemaking to amend the definitions of ''Underserved area'', ''Metropolitan area'' and ''Minority'', and to add a new definition of the term ''Home Purchase Mortgage'.

The rulemaking also invites comments on whether HUD should have a standard econometrically based method for imputing the distribution of GSE-purchased mortgages that lack income data, and whether HUD should revise its definitions or other rules (including the counting rules) to ensure that only those large scale GSE transactions that are consistent with the statute and its purposes qualify under the goals.

DATES: Comments must be submitted on or before: July 2, 2004.

ADDRESSES: Interested persons are invited to submit written comments regarding this proposed rule to the Regulations Division, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410. All communications should refer to the above docket number and title. Facsimile (FAX) comments and e-mail comments are *not* acceptable. A copy of each communication submitted will be available for public inspection and copying between 8 a.m. and 5 p.m. weekdays at the above address.

FOR FURTHER INFORMATION CONTACT: Sandra Fostek, Director, Office of Government Sponsored Enterprises, Office of Housing, Room 3150, telephone 202–708–2224. For questions on data or methodology, contact John L. Gardner, Director, Financial Institutions Regulation Division, Office of Policy Development and Research, Room 8212, telephone (202) 708–1464. For legal questions, contact Kenneth A. Markison, Assistant General Counsel for Government Sponsored Enterprises/RESPA or Paul S. Ceja, Deputy Assistant General Counsel for Government Sponsored Enterprises/RESPA, Office of the General Counsel, Room 9262, telephone 202–708–3137. The address for all of these persons is Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC, 20410. Persons with hearing and speech impairments may access the phone numbers via TTY by calling the Federal Information Relay Service at (800) 877–8399.

SUPPLEMENTARY INFORMATION:

I. General

A. Statutory and Regulatory Background

In 1968, at the time Fannie Mae was chartered in its current form as a government sponsored enterprise (GSE), Congress assigned the Department of Housing and Urban Development (''HUD'' or ''the Department'') regulatory authority over Fannie Mae pursuant to section 802(ee) of the Housing and Urban Development Act of 1968 (Pub. L. 90–448, approved August 1, 1968, 82 Stat. 476, 541) (HUD Act of 1968). In 1989, Congress granted the Department essentially identical authority over another GSE, Freddie Mac, pursuant to section 731 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (Pub. L. 101–73, approved August 9, 1989), which amended the Federal Home Loan Mortgage Corporation Charter Act, Pub. L. 91–351, approved July 24, 1970 (the ''Freddie Mac Charter Act'').

Under section 802(ee) of the HUD Act of 1968, HUD was authorized to require that a ''reasonable portion'' of Fannie Mae's mortgage purchases be related to the national goal of providing adequate housing for low- and moderate-income families. Accordingly, in 1978, the Department established by regulation two housing goals for Fannie Mae: a goal for mortgages on low- and moderate-income housing and a goal for mortgages on housing located in central cities (*see* 24 CFR 81.16(d) and 81.17 of HUD's former rules at 43 FR 39203, published August 15, 1978). HUD established each goal at the level of 30 percent of Fannie Mae's conventional mortgage purchases.

Similar housing goals for Freddie Mac were proposed by the Department in 1991 (at 56 FR 41022, published August 16, 1991) but were not finalized prior to October 1992, when Congress enacted FHEFSSA and revised the Department's GSE regulatory authorities, including establishing new requirements for the housing goals.

Specifically, FHEFSSA established the Office of Federal Housing Enterprise

Oversight (OFHEO) as the GSEs' safety and soundness regulator and affirmed, clarified and expanded the Secretary of Housing and Urban Development's GSE regulatory authority. FHEFSSA also provided that, except for certain exclusive authorities of the Director of OFHEO, and all other matters relating to the GSEs' safety and soundness, the Secretary had general regulatory power over the GSEs. (*See* section 1321 of FHEFSSA, 12 U.S.C. 4541.)

Further, FHEFSSA detailed and expanded the Department's responsibilities to establish, monitor, and enforce housing goals for the GSEs' purchases of mortgages that finance housing for low- and moderate-income families (the ''Low- and Moderate-Income Housing Goal''), housing located in central cities, rural areas, and other underserved areas (the ''Underserved Areas Housing Goal''), and special affordable housing, affordable to very low-income families and low-income families in low-income areas (the ''Special Affordable Housing Goal'') (collectively, the ''Housing Goals'' or, individually, the ''Housing Goal''). (*See*, generally, sections 1331–1334 of FHEFSSA, 12 U.S.C. 4561–4564.) There is also a subgoal under the Special Affordable Housing Goal for multifamily housing.

Under FHEFSSA, the Department is required to establish each Housing Goal after consideration of certain factors that are relevant to the particular Housing Goal, including: (a) National housing needs; (b) economic, housing and demographic conditions; (c) the performance and efforts of the GSEs toward achieving the Housing Goal in previous years; (d) the size of the market for mortgages targeted by the Housing Goal relative to the overall conventional mortgage market; (e) the ability of the GSEs to lead the industry in making credit available for mortgages targeted by the Housing Goal; and (f) the need to maintain the sound financial condition of the GSEs. (*See* sections 1332(b), 1333(a)(2), 1334(b) of FHEFSSA; 12 U.S.C. 4562(b); 12 U.S.C. 4563(a)(2); and 12 U.S.C. 4564.) (There are slight differences among the three Housing Goals in the statutory specification of the factors. In particular, for the Special Affordable Housing Goal factors (b) and (d) are absent, and there is a factor for data submitted in previous years to the Secretary in connection with the Housing Goal.)

For the transition period of 1993–1994, FHEFSSA required HUD to establish interim Housing Goals, which HUD did in 1993 (at 53 FR 53048). In November 1994, HUD extended the 1994 interim Housing Goals for both GSEs through 1995 while the Department completed its development of post-transition Housing Goals (*see* 59 FR 61504).

In 1995, the Department issued a proposed rule (60 FR 9154, published February 16, 1995) and, several months later, a final rule (60 FR 61846, published December 1, 1995) (the ''Housing Goals 1995 final rule'') establishing the Housing Goals for the years 1996 through 1999, along with regulations implementing FHEFSSA. The Housing Goals 1995 final rule provided that the Housing Goals for 1999 would continue beyond 1999 if the Department elected not to change the Housing Goals, and that HUD could change the level of the Housing Goals for the years 2000 and beyond based upon HUD's experience and in accordance with HUD's statutory authority and responsibility.

The Housing Goals 1995 final rule established counting requirements to calculate performance under the Housing Goals. The Housing Goals 1995 final rule also: (1) Prohibited the GSEs from discriminating in any manner, on any prohibited basis, in their mortgage purchases; (2) implemented procedures for the exercise of HUD's new program review authority; (3) established reporting requirements and a public use data base of the GSEs' mortgage purchase activities; (4) provided protections for GSE confidential and proprietary information; and (5) established enforcement procedures.

On March 9, 2000, HUD published a proposed rule to establish new Housing Goal levels for Fannie Mae and Freddie Mac for calendar years 2000 through 2003 (*see* 65 FR 12632–12816). On October 31, 2000, after analyzing over 250 comments, HUD issued a final rule establishing the new Housing Goals (the ''Housing Goals 2000 Final Rule,'' 65 FR 65044–65229).

The Housing Goals 2000 final rule increased the level of the Housing Goals for Fannie Mae and Freddie Mac. Specifically, this rule:

(1) Increased the level of the Housing Goals for calendar years 2001 through 2003 as follows:

- The Low- and Moderate-Income Housing Goal increased to 50 percent;
- The Underserved Areas Housing Goal increased to 31 percent;
- The Special Affordable Housing Goal increased to 20 percent;
- The Special Affordable Multifamily Subgoal increased to the respective average of one percent of each GSE's total mortgage purchases during the period of 1997 Through 1999; and
- Pending establishment of annual Housing Goals for the year 2004 and thereafter, the annual Housing Goals for each of those years were to be established at 50 percent, 31 percent, and 20 percent, respectively;

(2) Made temporary bonus points available for the GSEs' purchases of mortgages for small multifamily properties with 5 to 50 units, and, above a threshold, for single-family 2- to 4-unit owner-occupied rental properties, for calendar years 2001 through 2003 (but not for subsequent years, unless determined by HUD);

(3) Established a temporary adjustment factor (''TAF'') for Freddie Mac's purchases of mortgages on large multifamily properties (over 50 units) for calendar years 2001 through 2003;

(4) Prohibited high-cost mortgage loans with predatory features from receiving Housing Goals credit;

(5) Established and clarified counting rules under the Housing Goals for the treatment of missing affordability data, purchases of seasoned mortgage loans, purchases of federally insured mortgage loans and purchases of mortgage loans on properties with expiring assistance contracts;

(6) Established procedures for HUD's review of transactions to determine appropriate Housing Goal treatment; and

(7) Made certain definitional and technical corrections to the Housing Goals 1995 final rule.

The Housing Goals 2000 final rule provided for the award of temporary bonus points (double credit) toward the Housing Goals for both GSEs' mortgage purchases that financed single-family, owner-occupied 2–4 unit properties and 5–50 unit multifamily properties. Under the TAF, the rule also awarded Freddie Mac 1.2 units credit for each multifamily unit in property over 50 units.[1] The Housing Goals 2000 final rule made clear, however, that both of these measures were temporary, intended to encourage the GSEs to ramp up their efforts to meet financing needs that had not been well served. During the three years for which the temporary bonus points and TAF were established, HUD expected the GSEs to develop new, sustainable business relationships and purchasing strategies for the targeted needs.

At the end of the three years (2001–2003), the Department determined not to extend the bonus points or the TAF, after careful review of the facts and circumstances of performance under the Housing Goals. Data indicate that both GSEs increased their financing of units

[1] Congress increased the level of the TAF to 1.35 per unit, section 1002 of Pub. L. 106–554 (December 21, 2000).

targeted by the bonus points and the TAF.

B. Background: Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac were chartered by the Congress as government sponsored enterprises. Pursuant to section 301 of the Federal National Mortgage Association Charter Act (the ''Fannie Mae Charter Act'', 12 U.S.C. 1716, *et seq.*) and section 301(b) of the Federal Home Loan Mortgage Corporation Act (the ''Freddie Mac Charter Act'', 12 U.S.C. 1451, *et seq.*), the GSEs were chartered expressly to:

(1) Provide stability in the secondary market for residential mortgages;

(2) Respond appropriately to the private capital market;

(3) Provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and

(4) Promote access to mortgage credit throughout the nation (including central cities, rural areas, and other underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

As a result of their status as GSEs, Fannie Mae and Freddie Mac receive significant explicit benefits that are not enjoyed by fully private shareholder-owned corporations in the mortgage market. These benefits include:

• Conditional access to a $2.25 billion line of credit from the U.S. Treasury (*see* section 306(c)(2) of the Freddie Mac Charter Act and section 304(c) of the Fannie Mae Charter Act);

• Exemption from the securities registration requirements of the Securities and Exchange Commission and the States (*see* section 306(g) of the Freddie Mac Charter Act and section 304(d) of the Fannie Mae Charter Act); [2] and

• Exemption from all State and local taxes except property taxes (*see* section 303(e) of the Freddie Mac Charter Act and section 309(c)(2) of the Fannie Mae Charter Act).

Fannie Mae and Freddie Mac engage in two principal businesses: purchasing and otherwise investing in residential mortgages and guaranteeing securities backed by residential mortgages.

While the securities that the GSEs guarantee, and the debt instruments they issue, are explicitly not backed by the full faith and credit of the United States, and nothing in this proposed rule should be construed otherwise, such securities and instruments trade at yields only a few basis points over those of U.S. Treasury securities with comparable terms. Moreover, these securities also offer yields lower than those for securities issued by fully private firms that are more highly capitalized but otherwise comparable.

These factors, in addition to the fact that the market does not require that individual GSE securities be rated by a national rating agency, evidence that investors perceive that GSE-guaranteed securities have inherent advantages over other types of guaranteed securities in light of the GSEs' relationship to the Federal Government, including their public purposes, their Congressional charters, and the explicit benefits provided in their charters as described above.

Consequently, the GSEs are able to fund their operations at lower cost than other private firms with similar financial characteristics. In a recent report, the Congressional Budget Office (CBO) estimated this funding advantage for the year 2003 to be a $19.6 billion annual combined subsidy for both GSEs. Of this amount, CBO estimated that the GSEs retained about $6.2 billion, or approximately one-third of the subsidy, for their officers and shareholders, while the remainder accrued to borrowers.[3]

C. Secretary's Approach To Regulating the GSEs

In return for the public benefits they receive, Congress has mandated in the GSEs' Charter Acts that the GSEs carry out public purposes not required of other private sector entities in the housing finance industry.

Specifically, as indicated, the GSEs' Charter Acts require them to continually assist in the efficient functioning of the secondary market for residential mortgages, including mortgages for low- and moderate-income families that may involve a reasonable economic return that is less than the economic return on other mortgages. The GSEs also are required to promote access to mortgage credit throughout the nation, including central cities, rural areas, and other underserved areas. These statutory mandates obligate the GSEs to work to ensure that everyone in the nation has a reasonable opportunity to enjoy access to the mortgage financing benefits resulting from the activities of these enterprises.

The GSEs have achieved an important part of their mission: providing stability and liquidity to large segments of the housing finance markets. They have also increased their purchases of loans affordable to low-income families over the past decade since the affordable housing goals were put in place under FHEFSSA. Through partnership efforts, new product offerings, and flexible underwriting and purchase standards, both enterprises have reached out to underserved borrowers, as discussed below in this preamble and in the appendices.

The major premise of this proposed rule is that the GSEs must further utilize their entrepreneurial talents and power in the marketplace to genuinely ''lead the mortgage finance industry'' and to ''ensure that citizens throughout the country enjoy access to the public benefits provided by these federally related entities.'' (*See*, S. Rep. No. 282, 102d Cong., 2d Sess. 34 (1992).)

For example, despite the record national homeownership rate of 67.9 percent in 2002, certain segments of the population clearly have not benefited to the same degree that others have from the advantages and efficiencies provided by Fannie Mae and Freddie Mac. Problems continue to persist for low-income families and certain minorities:

• Lower homeownership rates prevail for certain minorities, especially for African-American households (47.9 percent) and Hispanics (48.2 percent). These gaps are only partly explained by differences in income, age, and other socioeconomic factors. Disparities in mortgage lending are reflected in loan denial rates of minority groups when compared to white applicants. Denial rates for conventional home purchase mortgage loans (excluding manufactured housing loans) in 2002 were 19.9 percent for African Americans, 14.0 percent for Native

[2] Fannie Mae and Freddie Mac have both announced their intention voluntarily to register their common stock with the Securities and Exchange Commission (SEC) under section 12(g) of the Securities Exchange Act of 1934. Fannie Mae's registration became effective March 31, 2003. Freddie Mac has stated that it will complete the process of voluntarily registering its common stock once it resumes timely reporting of its financial results.

[3] ''Updated Estimates of the Subsidies to the Housing GSEs'', attachment to a letter from Douglas Holtz-Eakin, Director, Congressional Budget Office, to the Honorable Richard C. Shelby, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate, April 8, 2004. A related recent study is Wayne Passmore, ''The GSE Implicit Subsidy and Value of Government Ambiguity,'' Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series, FEDS Working Paper 2003–64, December 2003.

American applicants, 15.1 percent for Hispanic applicants, 8.9 percent for Asian applicants, and 7.9 percent for White applicants.

• While Fannie Mae and Freddie Mac cannot be expected to solve all these problems, they have both the resources and the expertise to improve credit access for low- and moderate-income families, minority families, and families in underserved areas. The GSEs also have the ability to increase the financing of affordable multifamily rental housing. Yet, studies by HUD and others show that the GSEs generally have been less active in historically underserved markets where there is a need for additional sources of financing to address persistent housing and credit needs, and fully private companies, operating without the benefits of GSE status, perform better in these markets.

• Between 1999 and 2002, special affordable housing borrowers accounted for 14.4 percent of Fannie Mae's acquisitions of home purchase mortgage loans and 14.5 percent of Freddie Mac's acquisitions, at the same time that such mortgages accounted for 16.4 percent of home purchase loans originated in the overall conventional, conforming market (excluding B&C loans) in metropolitan areas.

• During the same period, mortgage purchases on properties located in underserved areas accounted for 24.0 percent and 22.9 percent of Fannie Mae's and Freddie Mac's acquisitions of home purchase loans, respectively, and 25.8 percent of home purchase mortgages originated in the primary market.

• Both Fannie Mae and Freddie Mac have lagged the market in funding first-time homebuyers. Between 1999 and 2002, first-time homebuyers accounted for 27 percent of each GSE's purchases of home purchase loans, compared with 38 percent for home purchase loans originated in the conventional conforming market.

Fannie Mae and Freddie Mac have increased their role in providing financing for the low-income end of the mortgage market, but the GSEs need to increase their efforts further and demonstrate their capacity to be industry leaders. There are ample market opportunities for them to do so, including:

• Continuing to introduce new products, and providing greater flexibility in their purchase and underwriting guidelines, to better address the unique circumstances of low-income families;

• Continuing to look for sound investment opportunities in those lower-income sectors that have not yet received the benefits of mainstream lenders supported by an active secondary market;

• Expanding their penetration in the following market segments: (1) Borrowers with credit blemishes, or with little traditional credit history; (2) first-time homebuyers; (3) Community Reinvestment Act (''CRA'')-related loans, which are loans to low- and moderate-income populations and neighborhoods in a financial institution's assessment area as established under the CRA; (4) the rental property market; and (5) the market for rehabilitation loans; and

• Increasing their outreach to, and achieving greater efficiency in, the above identified markets, as well as in other markets that serve low-income and moderate-income families and families living in underserved areas.

Under the present rulemaking, the Department is proposing new, higher levels for the Housing Goals, accompanied by subgoals under each of the Housing Goals for purchases of home purchase mortgages on owner-occupied properties in metropolitan areas. (The subgoals are hereafter referred to in this rule as ''Home Purchase Subgoal'' or ''Subgoal''.) The Department's purpose in proposing higher Housing Goals and in establishing new Home Purchase Subgoals in this rulemaking is to encourage the GSEs to facilitate greater financing and homeownership opportunities for families and neighborhoods targeted by the Housing Goals. In developing these regulations, the Department was guided by, and re-affirms, the following principles established in the Housing Goals 1995 final rule:

(1) The GSEs should fulfill FHEFSSA's intent that they lead the industry in ensuring that access to mortgage credit is made available for very low-, low- and moderate-income families and residents of underserved areas. HUD recognizes that, to lead the mortgage industry over time, the GSEs will have to stretch to reach certain Housing Goals and to close gaps between the secondary mortgage market and the primary mortgage market for various categories of loans. This approach is consistent with the Congress' directive that ''the enterprises will need to stretch their efforts to achieve'' the goals (*see* S. Rep. No. 282, 102d Cong., 2d Sess., 35 (1992)).

(2) The Department's role as a regulator is to set broad performance standards for the GSEs through the Housing Goals, but not to dictate the specific products or delivery mechanisms the GSEs will use to achieve a Housing Goal. Regulating two exceedingly large financial enterprises in a dynamic market requires that HUD provide the GSEs with sufficient latitude to use their innovative capacities to determine how best to develop products to carry out their respective missions. HUD's regulations are intended to allow the GSEs the flexibility to respond quickly to market opportunities. At the same time, the Department must ensure that the GSEs' strategies address national credit needs, especially as they relate to housing for low- and moderate-income families and housing located in underserved geographical areas. The addition of Home Purchase Subgoals to the regulatory structure provides an additional means of encouraging the GSEs' affordable housing activities to address identified, persistent credit needs while leaving to the GSEs the specific approaches to meeting these needs.

(3) Discrimination in lending—albeit sometimes subtle and unintentional—has denied racial and ethnic minorities the same access to credit to purchase a home that has been available to similarly situated non-minorities. As noted above, troublesome gaps in homeownership remain for minorities even after record growth in affordable lending and homeownership during the nineties. Studies indicate that, over the next few years, minorities will account for a growing share of the families seeking to buy their first home. HUD's analyses indicate, however, that Fannie Mae and Freddie Mac account for a relatively small share of the minority first-time homebuyer market. The GSEs have a responsibility to promote access to capital for minorities and others who are seeking their first homes, and to demonstrate the benefits of such lending to industry and borrowers alike. The GSEs also have an integral role in eliminating predatory mortgage lending practices.

(4) In addition to the GSEs' purchases of single-family home mortgages, the GSEs also must continue to assist in the creation of an active secondary market for mortgages on multifamily rental housing. Affordable rental housing is essential for those families who cannot afford to become, or who choose not to become, homeowners. For this reason, the GSEs must assist in making capital available to assure the continued development of single-family and multifamily rental housing.

With these principles in mind, the Department is proposing levels of the Housing Goals that will bring the GSEs to a position of market leadership in a range of foreseeable economic circumstances related to the future course of interest rates and consequent fluctuations in origination rates on home purchase and refinance mortgages—both multifamily and single-family. For each Goal, HUD has projected Goal-qualifying percentages of mortgage originations in terms of ranges that cover a variety of economic scenarios. The objective of HUD's proposed Housing Goals is to bring the GSEs' performance to the upper end of HUD's market range estimate for each Goal, consistent with the statutory criterion that HUD should consider the GSEs' ability to lead the market for each Goal. To enable the GSEs to achieve this leadership, the Department is proposing modest increases in Housing Goal levels for 2005 which will increase further, year-by-year through 2008, to achieve the ultimate objective for the GSEs to lead the market under a range of foreseeable economic circumstances by 2008. Such a program of staged increases is consistent with the statutory requirement that HUD consider the past performance of the GSEs in setting the Goals. Staged annual increases in the Goals will provide the enterprises with opportunity to adjust their business models and prudently try out business strategies, so as to meet the required 2008 levels without compromising other business objectives and requirements.

The Department believes that the Home Purchase Subgoals that it proposes to establish under this rulemaking are necessary and warranted. Increasing homeownership is a national priority. As detailed below, the GSEs must apply greater efforts to increasing homeownership for low- and moderate-income families, families living in underserved areas, and very-low income families and low-income families living in low-income areas. The addition of Home Purchase Subgoals to the regulatory structure will serve to better focus the GSEs' efforts in a clear and transparent manner and better allow the government and public alike to monitor the GSEs' efforts in meeting the nation's homeownership needs.

Moreover, the Department reaffirms its view that neither the award of bonus points for particular mortgage purchases nor the temporary adjustment factor for Freddie Mac's multifamily purchases are necessary. At this point, their continued use would only result in misleading information about the extent to which the GSEs are, in fact, meeting the Housing Goals. The decision to increase the levels of the Housing Goals substantially in a staged manner under this proposal and, at the same time, not to renew the bonus points or TAF, will ensure that the GSEs continue to address the areas formerly targeted by these measures. The business relationships that the GSEs established when these provisions were in place will be necessary to meet the higher Housing Goals.

The Department's proposals to increase the levels of the Housing Goals, and to establish new Home Purchase Subgoals, are predicated upon its recognition that the GSEs not only have the ability to achieve these Housing Goals but, also, that they are fully consistent with the statutory factors established under FHEFSSA. In addition, these proposals are supported by the Department's comprehensive analyses of the size of the mortgage market, the opportunities available to the GSEs, America's unmet housing needs, and identified credit gaps.

The Department anticipates that, as the GSEs' businesses grow, the increased level of the Housing Goals, and the new Home Purchase Subgoals, will enable the GSEs to continue to address new markets and persistent, unmet housing finance needs.

II. Implementation

A. Affordable Housing Goals

1. Proposed Changes to Housing Goal Levels

The current Housing Goal levels are 50 percent for the Low- and Moderate-Income Housing Goal, 31 percent for the Underserved Areas Housing Goal, and 20 percent for the Special Affordable Housing Goal. The Special Affordable Housing Goal includes a Subgoal for mortgage purchases financing dwelling units in multifamily housing which is 1.0 percent of the average annual dollar volume of mortgages (both single-family and multifamily) purchased by the respective GSE in 1997, 1998, and 1999—$2.85 billion annually for Fannie Mae and $2.11 billion annually for Freddie Mac.

The Department is proposing in this rulemaking to increase the Housing Goal levels as follows:

- The proposed level of the Low- and Moderate-Income Housing Goal is 52 percent in 2005, 53 percent in 2006, 55 percent in 2007, and 57 percent in 2008;
- The proposed level of the Underserved Areas Housing Goal is 38 percent in 2005, 39 percent in 2006, 39 percent in 2007, and 40 percent in 2008; and
- The proposed level of the Special Affordable Housing Goal is 22 percent in 2005, 24 percent in 2006, 26 percent in 2007, and 28 percent in 2008.
- In addition, HUD is proposing to retain the Special Affordable Multifamily Subgoal for calendar years 2005–2008, at 1.0 percent of their respective average dollar volumes of mortgage purchases in calendar years 2000, 2001, and 2002. This would increase the dollar value to $5.49 billion annually for Fannie Mae and $3.92 billion annually for Freddie Mac.

The Housing Goal percentages that are proposed in this rule reflect the application of area median incomes and minority percentages based on 2000 Census data, the Census Bureau's specification of census tract boundaries for the 2000 Census, and the Office of Management and Budget's specification of metropolitan area boundaries based on the 2000 Census.

2. HUD's Consideration of Statutory Factors in Setting the Housing Goals

As discussed above, HUD considered six statutory factors before it decided upon the levels of the Housing Goals being proposed in this rulemaking, as described in Section III(B) of this preamble and proposed rule amendment numbers 3–5 of this proposed rule. A summary of HUD's findings relative to each factor follows. More detailed discussion of these points is included in Appendices A, B, and C.

a. Demographic, Economic, and Housing Conditions

(i) *Demographic Trends.* Changing population demographics will result in a need for the primary and secondary mortgage markets to meet nontraditional credit needs, respond to diverse housing preferences and overcome information and other barriers that many immigrants and minorities face.

The U.S. Census Bureau has projected that the U.S. population will grow by an average of 2.5 million persons per year between 2000 and 2025, resulting in about 1.2 million new households per year. The aging of the baby-boom generation and the entry of the baby-bust generation into prime home-buying age will have a dampening effect on housing demand. Growing housing demand from minorities, immigrants and non-traditional homebuyers will help offset declines in the demand for housing caused by the aging of the population.

The continued influx of immigrants will increase the demand for rental housing, while those who immigrated during the 1980s and 1990s will be in the market for homeownership. Immigrants and minorities—who accounted for nearly 40 percent of the growth in the nation's homeownership rate over the past five years—will be responsible for almost two-thirds of the growth in the number of new households over the next ten years.

Non-traditional households have become more important, as overall household formation rates have slowed. With later marriages, divorce, and non-traditional living arrangements, the fastest growing household groups have been single-parent and single-person households. By 2025, non-family households will make up a third of all households. The role of traditional 25-to-34 year-old married, first-time homebuyers in the housing market will be smaller in the current decade due to the aging of the population. Between 2000 and 2025, the Census Bureau projects that the largest growth in households will occur among householders 65 and over.

As these demographic factors play out, the overall effect on housing demand will likely be continued growth and an increasingly diverse household population from which to draw new renters and homeowners. A greater diversity in the housing market will, in turn, require greater adaptation by the primary and secondary mortgage markets.

(ii) *Economic and Housing Conditions.* While most other sectors of the economy were weak or declining during 2001 and 2002, the housing sector showed remarkable strength. The housing market continued at a record pace during 2003.

In 2002, the U.S. economy moved into recovery, with real Gross Domestic Product (GDP) growing 2.2 percent, although measures of unemployment continued to rise. In October 2002, the average 30-year home mortgage interest rate slipped below 6 percent for the first time since the mid-1960s. Favorable financing conditions and solid increases in house prices were the key supports to record housing markets during both 2002 and 2003. By the end of 2003, the industry had set new records in single-family permits, new home sales, existing home sales, interest rates, and homeownership. Other indicators—total permits, starts, completions, and affordability—reached levels that were among the highest in the past two decades.

Over the near term, the Administration's forecast for real GDP growth is 4.0 percent for 2004, while the Congressional Budget Office (CBO) projects that real GDP will grow at an average rate of 3.2 percent from 2005 through 2008. The ten-year Treasury rate is projected to average 5.5 percent between 2005 and 2008 compared to its average of 4.6 percent in 2002 and 4.0 percent in 2003. Standard & Poor's expects housing starts to average 1.8 million units in 2004–05. Fannie Mae projects existing home sales at 6.1 million units for 2004 and 5.8 million for 2005, compared to their record 6 million level in 2003.

(iii) *Mortgage Market Conditions.* Low interest rates and record levels of refinancing caused mortgage originations to soar from $2.2 trillion in 2001 to $2.9 trillion in 2002 and around $3.8 trillion in 2003. Fannie Mae projects that mortgage originations will drop to $2.4 trillion in 2004 and $1.7 trillion in 2005, as refinancing returns to more normal levels. The volume of home purchase mortgages was $910 billion to $1.1 trillion between 1999 and 2001 before jumping to $1.2 trillion in 2002 and $1.3 trillion in 2003. As with housing starts, the home purchase origination market is expected to exhibit sustained growth.

b. National Housing Needs

(i) *Affordability Problems.* Data from the 2000 Census and the American Housing Surveys demonstrate that there are substantial housing needs among low- and moderate-income families. Many of these households are burdened by high homeownership costs or rent payments and, consequently, are facing serious housing affordability problems.

There is evidence of persistent housing problems for Americans with the lowest incomes. HUD's analysis of American Housing Survey data reveals that, in 2001, 5.1 million households had "worst case" housing needs, defined as housing costs greater than 50 percent of household income or severely inadequate housing among unassisted very-low-income renter households. Among these households, 90 percent had a severe rent burden, 6 percent lived in severely inadequate housing, and 4 percent suffered from both problems. Among the 34 million renters in all income categories, 6.3 million (19 percent) had a severe rent burden and over one million renters (3 percent) lived in housing that was severely inadequate.

(ii) *Disparities in Housing and Mortgage Markets.* Despite the strong growth in affordable lending over the past ten years, there are families who are not being adequately served by the nation's housing and mortgage markets.

Serious racial and income disparities remain. The homeownership rate for minorities is 25 percentage points below that for whites. A major HUD-funded study of discrimination in the sales and rental markets found that while discrimination against minorities was generally down since 1989, it remained at unacceptable levels in 2000. The most prevalent form of discrimination against Hispanic and African-American home seekers observed in the study was Hispanics and African Americans being told that housing units were unavailable when non-Hispanic whites found them to be available. The study also found other worrisome trends of discrimination in metropolitan housing markets that persisted in 2000, for example, geographical steering experienced by African-American homebuyers, and real estate agents who provided less assistance in obtaining financing for Hispanic homebuyers than for non-Hispanic whites.[4] Racial disparities in mortgage lending are also well documented. HUD-sponsored studies of the pre-qualification process conclude that African Americans and Hispanics face a significant risk of unequal treatment when they visit mainstream mortgage lenders. Studies have shown that mortgage denial rates are substantially higher for African Americans and Hispanics, even after controlling for applicant income and a host of underwriting characteristics, such as the credit record of the applicant.[5]

The existence of substantial neighborhood disparities in homeownership and mortgage credit is also well documented for metropolitan areas. HUD's analysis of HMDA data shows that mortgage credit flows in metropolitan areas are substantially lower in high-minority and low-income neighborhoods and mortgage denial rates are much higher for residents of these neighborhoods. Studies have also documented that mainstream lenders often do not operate in inner-city minority neighborhoods, leaving their residents with only high-cost lenders as options. Too often, residents of these same neighborhoods have been subjected to the abusive practices of predatory lenders.

These troublesome disparities mostly affect those families (minorities and immigrants) who are projected to account for almost two-thirds of the growth in the number of new households over the next ten years.

(iii) *Single-Family Market: Trends in Affordable Lending and Homeownership.* Many younger, minority and lower-income families did not become homeowners during the 1980s due to the slow growth of earnings, high real interest rates, and continued house price increases. Over the past ten years, economic expansion, accompanied by low interest rates and

[4] Margery Austin Turner, *All Other Things Being Equal: A Paired Testing Study of Mortgage Lending Institutions*, The Urban Institute Press, April 2002. Appendix A includes further discussion of this study.

[5] These studies are discussed in section B.1 of Appendix B.

increased outreach on the part of the mortgage industry, has improved affordability conditions for these families.

As this preamble and the appendices note, there has been a ''revolution in affordable lending'' that has extended homeownership opportunities to historically underserved households. The mortgage industry, including the GSEs, has offered more customized mortgage products, more flexible underwriting, and expanded outreach to low-income and minority borrowers.

HMDA data suggest that the industry and GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2002, conventional loans to low-income and minority families increased at much faster rates than loans to upper-income and non-minority families. Conventional home purchase originations to African-Americans more than doubled between 1993 and 2002 and those to Hispanic borrowers more than tripled during this period. Home loans to low-income borrowers and to low-income and high-minority census tracts also more than doubled during this period.

Thus, the 1990s and the early part of the current decade have seen the development of a strong affordable lending market. Homeownership statistics show similar trends. After declining during the 1980s, the homeownership rate has increased every year since 1994, reaching a record mark of 67.9 percent in 2002. The number of households owning their own home in 2002 was 10.6 million greater than in 1994. Gains in homeownership rates have been widespread over the last eight years, with the homeownership rate for African American households increasing from 42.5 percent to 47.9 percent, for Hispanic households from 41.2 percent to 48.2 percent, for non-Hispanic white households from 50.8 percent to 55.1 percent, and for central city residents from 48.5 percent to 51.8 percent from 1994 to 2002.

Despite the record gains in homeownership since 1994, a substantial gap in the homeownership rate of approximately 25 percentage points prevails for African-American and Hispanic households as compared to white non-Hispanic households. Studies show that these lower homeownership rates are only partly accounted for by differences in income, age, and other socioeconomic factors.

In addition to low income, barriers to homeownership that disproportionately affect minorities and immigrants include: lack of capital for down payment and closing costs; poor credit history; lack of access to mainstream lenders; little understanding of the home buying process; a limited supply of modestly priced homes; and continued discrimination in housing markets and mortgage lending. These barriers are discussed in Appendix A.

(iv) *Single-Family Market: Potential Homeowners.* As already noted, the potential homeowner population over the next decade will be highly diverse, as growing housing demand from immigrants (both those who are already in this country and those who are projected to arrive), minorities, and non-traditional homebuyers will help to offset declines in the demand for housing caused by the aging of the population.

Fannie Mae reports that, between 1980 and 1995, the number of new immigrant owners increased by 1.4 million and, between 1995 and 2010, that figure is expected to rise by more than 50 percent to 2.2 million. These trends do not depend on the future inflow of new immigrants, as immigrants do not, on average, enter the home purchase market until they have been in this country for eleven years. Fannie Mae staff note that there are enough immigrants already in this country to keep housing demand strong for several years.

Thus, the need for the GSEs and other industry participants to meet nontraditional credit needs, respond to diverse housing preferences, and to overcome the information barriers that many immigrants face will take on added importance. A new or recent immigrant may have no credit history or, at least, may not have a credit history that can be documented by traditional methods. In order to address these needs, the GSEs and the mortgage industry have been developing innovative products and seeking to extend their outreach efforts to attract these homebuyers, as discussed in Appendix A.

In addition, the current low homeownership rates in inner cities (as compared with the suburbs) also suggest that urban areas may be a potential growth market for lenders. As explained in Appendix A, lenders are beginning to recognize that urban borrowers and properties have different needs than suburban borrowers and properties. CRA-type lending will continue to be important in our inner cities.

Surveys indicate that these demographic trends will be reinforced by the fact that most Americans desire, and plan, to become homeowners. According to Fannie Mae's 2002 National Housing Survey, Americans rate homeownership as the best investment they can make, far ahead of 401(k)s, other retirement accounts, and stocks. Forty-two percent of African-American families reported that they were ''very or fairly likely'' to buy a home in the next three years, up from 38 percent in 1998 and 25 percent in 1997. Among Hispanics and Hispanic immigrants, the numbers reached 37 percent and 34 percent, respectively. The survey also reported that more than half of Hispanic renters cite homeownership as being ''one of their top priorities.''

In spite of these trends, potential minority and immigrant homebuyers see more obstacles to buying a home than does the general public. Typically, the primary barriers to homeownership are credit issues and a lack of funds for a downpayment and closing costs. However, other barriers also exist, such as a lack of affordable housing, little understanding of the home buying process, and language barriers. Thus, the new group of potential homeowners will have unique needs.

The GSEs can play an important role in tapping this potential homeowner population. Along with others in the industry, they can address these needs on several fronts, such as expanding education and outreach efforts, introducing new products, and adjusting current underwriting standards to better reflect the special circumstances of these new households. These efforts will be necessary if the Administration's goal of expanding minority homeownership by 5.5 million families by the end of the decade is to be achieved. (In this regard, the Joint Center for Housing Studies has stated that, if favorable economic and housing market trends continue, and if additional efforts to target mortgage lending to low-income and minority households are made, the homeownership rate could reach 70 percent by 2010.)

The single-family mortgage market has been very dynamic over the past few years, experiencing volatile swings in originations (with the 1998 and 2001–2003 refinancing waves), witnessing the rapid growth in new types of lending (such as subprime lending), incorporating new technologies (such as automated underwriting systems), and facing serious challenges (such as abusive predatory lending). Fannie Mae and Freddie Mac have played a major role in the ongoing changes in the single-family market and in helping the industry address the problems and challenges that have arisen.

The appendices to this proposed rule discuss the various roles that Fannie Mae and Freddie Mac have played in the single-family market. A wide range of topics is examined, including the GSEs' automated underwriting technology used throughout the industry, their many affordable lending partnerships and underwriting initiatives aimed at extending credit to underserved borrowers, their development of new targeted low-downpayment products, their entry into new markets such as subprime lending, and their attempts to reduce predatory lending. As that discussion emphasizes, the GSEs have the ability to bring increased efficiencies to a market and to attract mainstream lenders into markets. (Readers are referred to Appendices A–C for further discussion of the GSEs' role in different segments of the single-family mortgage market.)

(v) *Multifamily Mortgage Market.* The market for financing of multifamily apartments has reached record volume. The favorable long-term prospects for apartments, combined with record low interest rates, have kept investor demand for apartments strong and have also supported property prices.

Fannie Mae and Freddie Mac have been among those boosting their volumes of multifamily financing and both have introduced new programs to serve the multifamily market. Fannie Mae and, especially (considering its early withdrawal from the market), Freddie Mac have rapidly expanded their presence in the multifamily mortgage market under the Housing Goals.

Freddie Mac has successfully rebuilt its multifamily acquisition program, as shown by the increase in its purchases of multifamily mortgages: from $27 million in 1992 to $3 billion in 1997 and then to approximately $7 billion annually during the next three years (1998 to 2000), before rising further to $11.9 billion in 2001 and $13.3 billion in 2002. Multifamily units accounted for 8.4 percent of all dwelling units (both owner and rental) financed by Freddie Mac between 1999 and 2002.

Concerns regarding multifamily capabilities no longer constrain Freddie Mac's performance with regard to the Housing Goals. Although Fannie Mae never withdrew from the multifamily market, it has stepped up its activities in this area substantially, with multifamily purchases rising from $3.0 billion in 1992 to $9.4 billion in 1999, and $18.7 billion in 2001, and then declining slightly to $18.3 billion in 2002. Multifamily units accounted for 9.2 percent of all dwelling units (both owner and rental) financed by Fannie Mae between 1999 and 2002.

The increased role of Fannie Mae and Freddie Mac in the multifamily market has major implications for the Low- and Moderate-Income Housing and Special Affordable Housing Goals, since high percentages of multifamily units have affordable-level rents and can count toward one or both of these Housing Goals. However, the potential of the GSEs to lead the multifamily mortgage industry has not been fully developed. The GSEs' purchases between 1999 and 2002 accounted for only 30 percent of the multifamily units that received financing during this period. Certainly there are ample opportunities and room for expansion of the GSEs' share of the multifamily mortgage market.

The GSEs' size and market position between loan originators and mortgage investors make them the logical institutions to identify and promote needed innovations and to establish standards that will improve market efficiency. As their role in the multifamily market continues to grow, the GSEs will have the knowledge and market presence to push simultaneously for standardization and for programmatic flexibility to meet special needs and circumstances, with the ultimate goal of increasing the availability and reducing the cost of financing for affordable and other multifamily rental properties.

The long-term outlook for the multifamily rental market is sustained, moderate growth, based on favorable demographics. The minority population, especially Hispanics, provides a growing source of demand for affordable rental housing. ''Lifestyle renters'' (older, middle-income households) are also a fast-growing segment of the rental population.

At the same time, the provision of affordable housing units will continue to challenge suppliers of multifamily rental housing as well as policy makers at all levels of government. Low incomes, combined with high housing costs, define the difficult situation of millions of renter households. Housing cost reductions are constrained by high land prices and construction costs in many markets. Regulatory barriers at the state and local level have an enormous impact on the development of affordable rental housing. Government action—through land use regulation, building codes, and occupancy standards—is a major contributor to high housing costs.

Since the early 1990s, the multifamily mortgage market has become more closely interconnected with global capital markets, although not to the same degree as the single-family mortgage market. Loans on multifamily properties are still viewed as riskier by some than mortgages on single-family properties. Property values, vacancy rates, and market rents of multifamily properties appear to be highly correlated with local job market conditions, creating greater sensitivity in loan performance to economic conditions than may be experienced for single-family mortgages.

There is a need for an ongoing GSE presence in the multifamily secondary market, both to increase liquidity and to further affordable housing efforts. The potential for an increased GSE presence is enhanced by the fact that an increasing proportion of multifamily mortgages are now originated in accordance with secondary market standards. Small multifamily properties, and multifamily properties with significant rehabilitation needs, have historically experienced difficulty gaining access to mortgage financing, and the flow of capital into multifamily housing for seniors has been historically characterized by volatility. The GSEs can play a role in promoting liquidity for multifamily mortgages and increasing the availability of long-term, fixed rate financing for these properties.

c. GSEs' Past Performance and Effort Toward Achieving the Housing Goals

Both Fannie Mae and Freddie Mac have improved their affordable housing loan performance over the past ten years, since the enactment of FHEFSSA and HUD's establishment in 1993 of the Housing Goals. However, the GSEs' mortgage purchases have generally lagged, and not led, the overall primary market in providing financing for affordable housing to low- and moderate-income families and underserved borrowers and their neighborhoods, indicating that there is more that the GSEs can do to improve their performance.

(i) *Performance on the Housing Goals.* The year 2001 was the first year under the higher levels of the Housing Goals established in the Housing Goals 2000 final rule. Both GSEs met all three Housing Goals in 2001 and 2002. Their performance is discussed further in a later section of this preamble.

(ii) *The GSEs' Efforts in the Home Purchase Mortgage Market.* The Appendices include a comprehensive analysis of each GSE's performance in funding home purchase mortgages for borrowers and neighborhoods targeted by the three Housing Goals—special affordable and low- and moderate-income borrowers and underserved areas. The GSEs' role in the first-time homebuyer market is also analyzed. Because homeownership opportunities are integrally tied to the ready availability of affordable home purchase loans, the main findings from that analysis are provided below:

• Both Fannie Mae and Freddie Mac have increased their purchases of affordable loans since the Housing Goals were put into effect, as indicated by the increasing share of their business going to the three Goals-qualifying categories. Between 1992 and 2002, the special affordable share of Fannie Mae's purchases of home purchase loans in metropolitan areas more than doubled, rising from 6.3 percent to 16.3 percent, while the underserved areas share increased more modestly, from 18.3 percent to 26.7 percent. The figures for Freddie Mac are similar. The special affordable share of Freddie Mac's business rose from 6.5 percent to 15.8 percent, while the underserved areas share increased more modestly, from 18.6 percent to 25.8 percent.

• While both GSEs improved their performance, they have lagged the primary market in providing affordable loans to low-income borrowers and underserved neighborhoods. Freddie Mac's average performance, in particular, fell far short of market performance during the 1990s. Fannie Mae's performance was better than Freddie Mac's during 1993–2002, as well as during 1996–2002, which covers the period under HUD's currently-defined Housing Goals. For the 1996–2002 period, 21.7 percent of Freddie Mac's purchases financed properties in underserved neighborhoods, compared with 23.5 percent of Fannie Mae's purchases, 24.9 percent of loans originated by depository institutions (*i.e.*, banks and savings associations), and 25.4 percent of loans originated in the conventional conforming market (*i.e.*, loans below the conforming loan limit that are not government insured or guaranteed).

• During the more recent 1999-to-2002 period, both Fannie Mae and Freddie Mac fell significantly below the market in funding special affordable loans. During that period, special affordable loans accounted for 14.4 percent of Fannie Mae's purchases, 14.5 percent of Freddie Mac's purchases, and 16.4 percent of loans originated in the market. Thus, the ''Fannie Mae-to-market'' ratio was 0.88 (14.4/16.4), as was the ''Freddie Mac-to-market'' ratio. Between 1999 and 2002, underserved area loans accounted for 24.0 percent of Fannie Mae's purchases, 22.9 percent of Freddie Mac's purchases, and 25.8 percent of loans originated in the market, resulting in a ''Fannie Mae-to-market'' ratio of 0.93 and a ''Freddie Mac-to-market'' ratio of 0.89.

• Both GSEs, but particularly Fannie Mae, markedly improved their performance during 2001 and 2002, the first two years under HUD's higher Housing Goal targets. Evaluating their activity relative to the market depends, to some extent, on the way in which GSE activity is measured. Under the purchase-year approach for measuring GSE activity (in which characteristics of mortgages purchased by a GSE in a particular year, including mortgages originated in prior years, are compared with characteristics of mortgages originated just within the year), Fannie Mae's average performance during 2001 and 2002 matched the market in the low- and moderate-income category and approached the market in the special affordable and underserved areas categories. For example, during 2001 and 2002, loans for special affordable borrowers accounted for 15.6 percent of Fannie Mae's purchases, compared with 16.0 percent of market originations. As explained in Appendix A, conclusions about Fannie Mae's recent performance relative to the market depend significantly on whether GSE activity is measured on a ''purchase year'' basis or on an ''origination year'' basis (in which characteristics of mortgages originated in a particular year are compared with characteristics of mortgages that were originated in that year and purchased by a GSE in that year or a subsequent year). Fannie Mae matched the market in the low- and moderate-income category in 2002, using the more consistent ''origination year'' approach. (*See* Appendix A for further discussion.)

• While Freddie Mac has consistently improved its performance relative to the market, it continued to lag the market in all three Housing Goal categories during 2001 and 2002. For example, during 2001 and 2002, loans financing properties in underserved areas accounted for 24.1 percent of Freddie Mac's purchases, compared with 25.9 percent of market originations.

• Appendix A to this rule compares the GSEs' funding of first-time homebuyers with that of primary lenders in the conventional conforming market. Both Fannie Mae and Freddie Mac lag the market in funding first-time homebuyers, and by a rather wide margin. Between 1999 and 2002, first-time homebuyers accounted for 27 percent of each GSE's purchases of home loans, compared with 38 percent for home loans originated in the conventional conforming market.

• The GSEs account for a small share of the market for important groups such as minority first-time homebuyers. Considering all mortgage originations (both government and conventional) between 1999 and 2001, it is estimated that the GSEs purchased only 14 percent of all loans originated for African-American and Hispanic first-time homebuyers, or one-third of their share (42 percent) of all home purchase loans originated during that period. Considering conventional conforming originations during the same time period, it is estimated that the GSEs purchased only 31 percent of loans for African-American and Hispanic first-time homebuyers, or about one-half of their share (57 percent) of all home purchase loans in that market. A large percentage of the lower-income loans purchased by the GSEs had relatively low loan-to-value ratios and consequently high down payments, which may explain the GSEs' limited role in the first-time homebuyer market.

d. Size of the Mortgage Market That Qualifies for the Housing Goals

The Department estimates the size of the conventional, conforming market for loans that would qualify under each Housing Goal category. The market estimates (which reflect 2000 Census data and geography) are as follows:

• 51–57 percent for the Low- and Moderate-Income Housing Goal
• 24–28 percent for the Special Affordable Housing Goal
• 35–40 percent for the Underserved Areas Housing Goal (based on 2000 Census geography).

These market estimates exclude the B&C (subprime loans that are not A minus grade) portion of the subprime market. The estimates, expressed as ranges, allow for economic and market affordability conditions that are more adverse than recent conditions. The market estimates are based on several mortgage market databases such as Home Mortgage Disclosure Act (HMDA) and American Housing Survey data. The Department's estimates of the size of the conventional mortgage market for each Housing Goal are discussed in detail in Appendix D.

The GSEs have substantial room for growth in serving the affordable housing mortgage market. The Department estimates that the two GSEs' mortgage purchases accounted for 49 percent of the total (single-family and multifamily) conventional, conforming mortgage market between 1999 and 2002. In contrast, GSE purchases comprised 42 percent of the low- and moderate-income market, 41 percent of the underserved areas market, and a still smaller 35 percent of the special affordable market. Thus, 58–65 percent of the Goals-qualifying markets have not yet been touched by the GSEs.

The GSEs' presence in mortgage markets for rental properties, where much of the nation's affordable housing is concentrated, is below that in the single-family-owner market. The GSEs' share of the rental market (including both single-family and multifamily) was only 30 percent during the 1999-to-2002 period. Obviously, there is room for the GSEs to increase their presence in the single-family rental and multifamily rental markets.

Table 1 summarizes the Department's findings regarding GSE performance relative to HUD's market estimates for 1999–2002, market projections for 2005–2008, and the proposed Housing Goal levels for 2005–2008.

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Table 1

Market Estimates, Baseline Performance and HUD's Proposed Housing Goals

	2001-2004 Housing Goals	2005-2008 Proposed Housing Goals				GSEs' Average Baseline Performance 1999-2002 (Fannie Mae/ Freddie Mac)	HUD's Estimated 1999-2002 Market Average[1]	HUD's Projected Market Estimate
		2005	2006	2007	2008			
Low- and Moderate-Income	50%	52%	53%	55%	57%	49% 47%	57%	51-57%
Underserved Areas	31%*	38%	39%	39%	40%	35% 33%	39%	35-40%
Special Affordable	20%	22%	24%	26%	28%	20% 19%	28%	24-28%

[1] See Appendix D for reasons why the 1999-2002 average market estimate for special affordable loans is at the top end of the market range projected for the years 2005-2008.

* Equivalent to 36% based on 2000 census tract geography, Metropolitan Statistical Areas as specified in 2003, and 2000 census data on area median income and minority concentrations.

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The analysis reflected in Table 1 is based on 2000 Census data on area median incomes and minority concentrations, with the metropolitan area boundaries specified in June 2003 by the Office of Management and Budget. This affects the market percentages for all three Housing Goals, as well as the figures on area median incomes and minority percentage figures that will be used to measure GSE performance on the Housing Goals beginning in 2005. For example, expressing the Underserved Areas Housing Goal in terms of 2000 Census data adds approximately 5 percentage points to the Housing Goal and market levels, compared with analysis using 1990 Census data with Metropolitan Statistical Areas as defined prior to 2000.

The GSEs' baseline performance figures in Table 1 exclude the effects of the bonus points for small multifamily and single-family 2–4 unit owner-occupied properties and the Temporary Adjustment Factor for Freddie Mac which were applied in official scoring toward the Housing Goals in 2001–2003. The Department did not extend these adjustments beyond 2003.

Table 1 reveals several features of HUD's proposed Housing Goals. First, the high end of the range for HUD's 2005–2008 market projections is the same as or within one percentage point of the 1999–2002 average of the market levels for the Housing Goals.

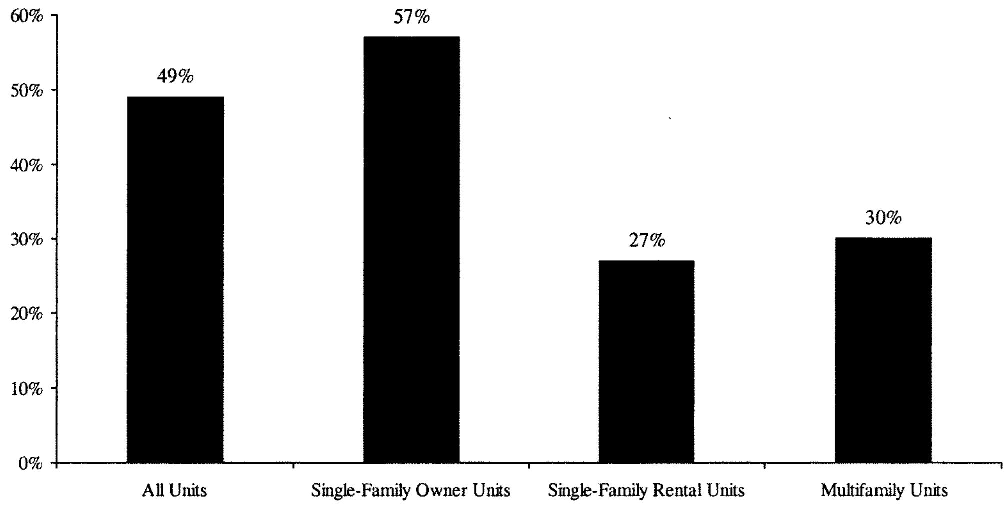
Second, it is evident from this table that the proposed initial new level for the Special Affordable Housing Goal (22 percent) is below the low end of HUD's projected market range for 2005–2008 (24 percent). The proposed initial level of the Low- and Moderate-Income Housing Goal (52 percent) is at the low-end of HUD's market estimate range.

Third, the proposed initial Underserved Areas Housing goal level is more consistent than the current Goal level with the market range now projected by HUD for the Housing Goals using 2000 Census data.

Fourth, the GSEs' performance on all of the Housing Goals was significantly below the market average for 1999–2002. The higher Housing Goals are intended to move the GSEs closer to or within the market range for 2005 and to the upper end of the market range projection by 2008.

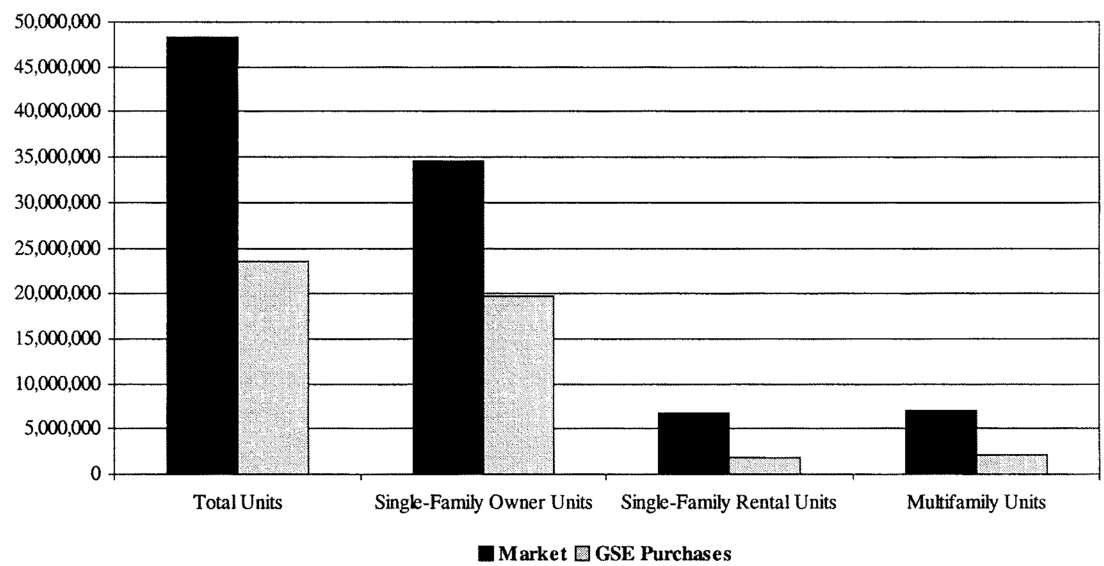
An analysis of the GSEs' mortgage purchases by property type shows that they have had much less presence in the ''Goals-rich'' rental segments of the market, as compared with the ''less-Goals-rich'' owner segment of the market. As shown in Figure 1, GSE mortgage purchases represented only 27 percent of single-family rental units financed between 1999 and 2002, and only 30 percent of multifamily units financed during that time period—both figures are much lower than their 57 percent market share for single-family owner-occupied properties. (Figure 2 provides unit-level detail comparing the GSEs' purchases with originations in the conventional conforming market.) Typically, about 90 percent of rental units in single-family rental and multifamily properties qualify for the Low- and Moderate-Income Housing Goal, compared with about 44 percent of owner units. Corresponding figures for the Special Affordable Housing Goal are approximately 60 percent of rental units and 16.4 percent of owner units. Thus, one reason that the GSEs' performance under the Low- and Moderate-Income Housing and Special Affordable Housing Goals has fallen short of HUD's market estimates is that the GSEs have had a relatively small presence in the two rental market segments, notwithstanding that these market segments are important sources of affordable housing and important components in HUD's market estimates.

Figure 1
GSEs' Share of the Conventional Conforming Market by Property Type, 1999-2002



Source: See Table A.30. Appendix A.

Figure 2
Units in the Conventional Conforming Mortgage Market Compared to GSE Purchases by Property Type, 1999-2002



Source: See Table A.30, Appendix A.

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In the overall conventional conforming mortgage market, rental units in single-family properties and in multifamily properties are expected to represent approximately 30 percent of the overall mortgage market, 45 percent of the units that collateralize mortgages qualifying for the Low- and Moderate-Income Housing Goal, and 60 percent of the units that collateralize mortgages qualifying for the Special Affordable Housing Goal. Yet between 1999 and 2002, units in such properties accounted for only 17 percent of the GSEs' overall purchases, 31 percent of the GSEs' purchases meeting the Low- and Moderate-Income Housing Goal, and 44 percent of the GSEs' purchases meeting the Special Affordable Housing Goal.[6] The continuing weakness in GSE purchases of mortgages on single-family rental and multifamily properties is a significant factor explaining the shortfall between GSE performance and that of the primary mortgage market.

e. Ability of the GSEs To Lead the Industry

An important factor in determining the overall Housing Goal level is the ability of the GSEs to lead the industry in making mortgage credit available for Housing Goals-qualifying populations and areas.

The legislative history of FHEFSSA reflects Congress's strong concern that the GSEs need to do more to benefit low- and moderate-income families and residents of underserved areas that lack access to credit. (*See, e.g.,* S. Rep. 102–282 at 34.) The Senate Report on FHEFSSA emphasized that the GSEs should ''lead the mortgage finance industry in making mortgage credit available for low- and moderate-income families.'' (*See* S. Rep. 102–282 at 34.)

Thus, FHEFSSA specifically requires that HUD consider the ability of the GSEs to lead the industry in establishing the level of the Housing Goals. FHEFSSA also clarified the GSEs' responsibility to complement the requirements of the CRA (*see* section 1335(a)(3)(B) of FHEFSSA, 12 U.S.C. 4565(a)(3)(B)), and fair lending laws (*see* section 1325 of FHEFSSA, 12 U.S.C. 4545) in order to expand access to capital to those historically underserved by the housing finance market.

While leadership may be exhibited through the GSEs' introduction of innovative products, technology, and processes, and through their establishment of partnerships and alliances with local communities and community groups, leadership must always involve increasing the availability of financing for homeownership and affordable rental housing. Thus, the GSEs' obligation to ''lead the industry'' entails leadership in facilitating access to affordable credit in the primary market for borrowers at different income levels, and with different housing needs, as well as in underserved urban and rural areas.

Because the GSEs' market presence varies significantly by property type, the Department examined whether the GSEs have led the industry in three different market sectors served by the GSEs: single-family-owner, single-family rental (those with at least one rental unit and no more than four units in total), and multifamily rental.

The GSEs' purchases between 1999 and 2002 financed almost 60 percent of the approximately 35 million owner-occupied units financed in the conventional conforming market during that period. The GSEs' state-of-the-art technology, staff resources, share of the total conventional conforming market, and financial strength strongly suggest that they have the ability to lead the industry in making home purchase credit available for low-income families and underserved neighborhoods. From the analysis in Appendices A–D, it is clear that the GSEs are able to improve their performance and lead the primary market in financing Housing Goals-qualifying home purchase mortgages.

As discussed in Appendix A, there are a wide variety of quantitative and qualitative indicators that demonstrate that the GSEs have ample, indeed robust, financial strength to improve their affordable lending performance. For example, the combined net income of the GSEs has risen steadily over the last 15 years, from $677 million in 1987 to $10.4 billion in 2002. This financial strength provides the GSEs with the resources to lead the industry in making mortgage financing available for families and neighborhoods targeted by the Housing Goals.

The GSEs have been much less active in providing financing for the multifamily rental housing market. Between 1999 and 2002, the GSEs financed 2.2 million multifamily dwelling units, which represented approximately 30 percent of the 7.0 million multifamily dwelling units that were financed in the conventional market during this period. Thus, the GSEs' share of the multifamily mortgage market was just slightly over one-half of their share of the market for mortgages on single-family owner-occupied properties.

Similarly, HUD estimates that Fannie Mae and Freddie Mac accounted for only 27 percent of single-family rental units financed between 1999 and 2002. In this case, the GSEs' presence in the single-family rental mortgage market was less than one-half their presence in the market for mortgages on single-family owner-occupied properties.

Clearly there is room for the GSEs to increase their presence in the single-family rental and multifamily rental markets. As explained above, these markets are an important source of low- and moderate-income housing since these units qualify for the Housing Goals in a greater proportion than do single-family owner-occupied properties. Thus, Fannie Mae and Freddie Mac can improve their performance on each of the three Housing Goals if they increase their purchases of mortgages on rental properties.

As discussed in Section B below with respect to the Home Purchase Subgoals, the GSEs should be able to lead the market for single-family owner-occupied properties. The GSEs are already dominant players in this market which, unlike the rental markets, is their main business activity. However, as already discussed, research studies conducted by HUD and academic researchers conclude that the GSEs have not been leading this market, but have historically lagged behind the primary market in financing owner-occupied housing for low-income families, first-time homebuyers, and housing in underserved areas.

f. Need To Maintain the Sound Financial Condition of the GSEs

Based on HUD's economic analysis and review by the Office of Federal Housing Enterprise Oversight, the Department has concluded that the proposed levels of the Housing Goals will not adversely affect the sound financial condition of the GSEs. Further discussion of this issue is found in the economic analysis that accompanies this rule.

3. Other Factors Considered by HUD in Proposing the New Housing Goals

HUD considered a number of additional factors in connection with its proposal to establish the new Housing Goals described in this rule. These additional factors also were relevant to HUD's proposal to establish the new Home Purchase Subgoals. The Department describes these additional factors in Section B of this preamble (*see*, ''Home Purchase Subgoals'' immediately below).

[6] These percentage shares are computed from Table A.30 in Appendix A. Note that B&C loans are excluded from these data.

B. Home Purchase Subgoals

Given the need for, and the Administration's emphasis on, increasing homeownership opportunities, including those for low- and moderate-income and minority borrowers, HUD is proposing also to set Subgoals for GSE mortgage purchase activities to increase financing opportunities for low- and moderate-income, underserved, and special affordable borrowers who are purchasing single-family homes.

Specifically, the Department is proposing Subgoals for home purchase loans that qualify for the Housing Goals. The purpose of the Home Purchase Subgoals is to assure that the GSEs focus on financing home purchases for the homeowners targeted by the Housing Goals. The Department believes that the establishment of Home Purchase Subgoals will place the GSEs in an important leadership position in the Housing Goals categories, while also facilitating homeownership. The GSEs have years of experience in providing secondary market financing for single-family properties and are fully capable of exerting such leadership.

The focus of these Subgoals on home purchase loans meeting the Housing Goals will also help address the racial and income disparities in homeownership that exist today. Although minority homeownership has grown, the homeownership rate for African Americans and Hispanic families is still approximately 25 percentage points below that for non-Hispanic white families. The focus of the Subgoals on home purchase will also increase the GSEs' support of first-time homebuyers, a market segment where they have lagged primary lenders.

The Department's analysis suggests that the GSEs have not been leading the market in purchasing single-family, owner-occupied loans that qualify for the Housing Goals. Although Fannie Mae's average performance during 2001 and 2002 matched the market in the low- and moderate-income category, and approached the market in the special affordable and underserved areas categories, the Department's analysis shows that there is ample room for both Fannie Mae and Freddie Mac to improve their performance in purchasing home loans that qualify for these Housing Goals, particularly in important market segments such as the minority, first-time homebuyer market.

As detailed in Appendix A, evidence suggests that there is a significant population of potential homebuyers who are likely to respond well to increased homeownership opportunities produced by increased GSE purchases in this area. Immigrants and minorities, in particular, are expected to be a major source of future homebuyers. Furthermore, studies indicate the existence of a large untapped pool of potential homeowners among the rental population. Indeed, the GSEs' recent experience with new outreach and affordable housing initiatives confirms the existence of this potential.

Thus, the Department is proposing to establish Subgoals for home purchase loans that qualify for the three Housing Goals to encourage the GSEs to take a leadership position in creating homeownership financing opportunities within the categories that Congress expressly targeted with the Housing Goals.

1. Proposed Home Purchase Subgoals

Under this proposed rule, performance on the Home Purchase Subgoals would be calculated as Housing Goal-qualifying percentages of the GSEs' total purchases of mortgages that finance purchases of single-family, owner-occupied properties located in metropolitan areas, based on the owner's income and the location of the property. Specifically, for each GSE the following proposed Subgoals would apply. (A ''home purchase mortgage'' is defined as a residential mortgage for the purchase of an owner-occupied single-family property.)

- 45 percent of home purchase mortgages purchased by the GSE in metropolitan areas must qualify under the Low- and Moderate-Income Housing Goal in 2005, with this share rising to 46 percent in 2006 and 47 percent in both 2007 and 2008;
- 33 percent of home purchase mortgages purchased by the GSE in metropolitan areas must qualify under the Underserved Areas Housing Goal in 2005, with this share rising to 34 percent in 2006 and 35 percent in both 2007 and 2008; and
- 17 percent of home purchase mortgages purchased by the GSE in metropolitan areas must qualify under the Special Affordable Housing Goal in 2005, with this share rising to 18 percent in 2006 and 19 percent in both 2007 and 2008.

Counting toward the Subgoals will be in terms of numbers of mortgages, not numbers of units. This is consistent with the basis of reporting in HMDA data, which were HUD's point of reference in establishing the Subgoal levels. HMDA data are reported in terms of numbers of mortgages.

These proposed Subgoals are shown in Table 2, along with information on what the GSEs' performance on the Subgoals would have been if they had been in effect for 1999–2002 (under the proposed scoring rules for 2005–08). Table 2 also presents HUD's estimates of the average shares of mortgages on owner-occupied single-family properties in metropolitan areas that were originated in 1999–2002 that would have qualified for these Subgoals.

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Table 2

Shares of GSEs' Acquisitions of Home Purchase Mortgages Qualifying for the Subgoals, 1999-2002, and Proposed Subgoals for 2005-08

	Subgoal-Qualifying Mortgage Purchases*				Proposed Subgoals				Market**				
Subgoal Catetory	1999	2000	2001	2002	2005	2006	2007	2008	1999	2000	2001	2002	Average
Low- and Moderate-Income													
Fannie Mae	39.2%	40.1%	41.7%	43.6%	45%	46%	47%	47%					
Freddie Mac	40.0%	41.7%	39.8%	42.1%									
Market									44.0%	43.7%	41.6%	43.1%	43.1%
Underserved Areas													
Fannie Mae	25.7%	29.1%	29.8%	32.3%	33%	34%	35%	35%					
Freddie Mac	26.1%	27.4%	27.4%	31.7%									
Market									30.2%	32.0%	30.7%	32.1%	31.2%
Special Affordable													
Fannie Mae	12.5%	13.4%	14.7%	15.8%	17%	18%	19%	19%					
Freddie Mac	12.8%	14.5%	13.9%	15.1%									
Market									17.1%	17.0%	15.4%	15.7%	16.3%

* Based on proposed counting rules for 2005-08. Projected subgoals would apply to metropolitan areas only. See text for definition of subgoal-qualifying mortgages.

** Conventional conforming market for home purchase mortgages in metropolitan areas (excluding the B&C portion of the subprime market.)

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2. HUD's Determinations Regarding the Home Purchase Subgoal Levels

Current law does not require that HUD consider the statutory factors set forth in FHEFSSA prior to establishing or setting the level of Subgoals. FHEFSSA authorizes HUD to establish Subgoals within the Low- and Moderate-Income Housing Goal and the Underserved Areas Housing Goal. However, under current law, Subgoals under these two Goals are not enforceable. Also, FHEFFSA authorizes HUD to establish Subgoals within the Special Affordable Housing Goal and these Subgoals are enforceable. The Administration has proposed, as part of GSE regulatory reform, that Congress authorize HUD to establish a separate Home Purchase Goal that would include enforceable components. Pending the enactment of any such legislation, HUD is proposing the Subgoals described in this proposed rule under its current statutory authority.

The following sections provide an overview of HUD's reasons for establishing the Subgoals, which are detailed in the Appendices.

(a) *The GSEs Have the Ability to Lead the Market.* The GSEs have the ability to lead the primary market for mortgages on single-family owner-occupied properties, which are the ''bread-and-butter'' of their business. Both GSEs have long experience in the home purchase mortgage market, and therefore there is no issue of the degree to which they have penetrated the market, as there is with the single-family rental and multifamily mortgage markets. In addition, because the Subgoals focus on homeownership opportunities and, thus, do not include refinance loans, there is no issue regarding potentially large year-to-year changes in refinance mortgage volumes, which affect the magnitude of the denominator in calculating performance percentages under the Housing Goals, as experienced in the heavy refinance years of 1998 and 2001–2003.

Both GSEs have not only been operating in the single-family owner mortgage market for years, they have been the dominant players in that market, funding 57 percent of mortgages on single-family owner-occupied residences financed between 1999 and 2002. As discussed in Section G of Appendix A, their underwriting guidelines are industry standards and their automated mortgage systems are widely used in the mortgage industry.

Through their new low-downpayment products and various underwriting initiatives, and through their various partnership and outreach efforts, the GSEs have shown that they have the capacity to operate in underserved neighborhoods and to reach out to lower-income families seeking to buy a home. Both Fannie Mae and Freddie Mac have the staff expertise and financial resources to make the extra effort to lead the primary market in funding single-family-owner mortgages for low- and moderate-income, special affordable, and underserved area mortgages.

(b) *The GSEs Have Lagged the Market.* Even though the GSEs have the ability to lead the market, they have not done so under the Housing Goals. As noted earlier, the Department and independent researchers have published numerous studies examining whether or not the GSEs have been leading the single-family market in terms of funding loans that qualify for the three Housing Goals. While the GSEs have significantly improved their performance, they have lagged the primary market in funding Housing Goals-qualifying loans since FHEFSSA was enacted in 1992.

As also noted above, the type of improvement needed to meet the new Subgoals was demonstrated by Fannie Mae during 2001 and 2002, when its average performance matched the primary market in funding low- and moderate-income families and approached the market in funding special affordable families and properties in underserved areas.

(c) *Disparities in Homeownership and Credit Access Remain.* There remain troublesome disparities in our housing and mortgage markets, even after the ''revolution in affordable lending'' and the growth in homeownership that has taken place since the mid-1990s. The homeownership rate for African-American and Hispanic households remains 25 percentage points below that of white households. In 2002, the mortgage denial rate for African-American borrowers was over twice that for white borrowers, even after controlling for the income of the borrower.

There is growing evidence that inner city neighborhoods are not always being adequately served by mainstream lenders. Some have concluded that a dual mortgage market has developed in our nation, with conventional mainstream lenders serving mainly white families living in the suburbs and FHA and subprime lenders serving minority families concentrated in inner city neighborhoods. In addition to the unavailability of mainstream lenders, families living in high-minority neighborhoods generally face many additional hurdles, such as lack of cash for a downpayment, credit problems, and discrimination.

Immigrants and minorities are projected to account for almost two-thirds of the growth in the number of new households over the next ten years. As emphasized throughout this preamble and the Appendices, changing population demographics will result in a need for the primary and secondary mortgage markets to meet nontraditional credit needs, respond to diverse housing preferences and overcome information and other barriers that many immigrants and minorities face. The GSEs must increase their efforts towards providing financing for these families.

(d) *There Are Ample Opportunities for the GSEs to Improve Their Performance in the Home Purchase Market.* Home purchase loans that qualify for the Housing Goals are available for the GSEs to purchase, which means they can improve their performance and lead the primary market in purchasing loans for lower-income borrowers and properties in underserved areas. Three indicators of this have already been discussed.

First, the affordable lending market has shown an underlying strength over the past few years that is unlikely to vanish (without a significant increase in interest rates or a decline in the economy). Since 1999, the shares of the home purchase market accounted for by the three Housing Goal categories are as follows: 16.4 percent for special affordable, 32.3 for underserved areas, and 44.2 percent for low- and moderate-income.

Second, market share data reported in Section G of Appendix A show that over half of newly-originated loans that qualify for the Housing Goals are not purchased by the GSEs. As noted above, the situation is even more extreme for special sub-markets, such as the minority first-time homebuyer market where the GSEs have only a minimal presence. In terms of the overall mortgage market (both conventional and government), the GSEs funded only 24 percent of all first-time homebuyers and 17 percent of minority first-time homebuyers between 1999 and 2001. Similarly, during the same period, the GSEs funded only 40 percent of first-time homebuyers in the conventional conforming market, and only 33 percent of minority first-time homebuyers in that market.

Finally, the GSEs' purchases that can count toward the Subgoal are not limited to new mortgages that are originated in the current calendar year. The GSEs can purchase loans from the substantial, existing stock of affordable loans held in lenders' portfolios, after these loans have seasoned and the GSEs have had the opportunity to observe their payment performance. In fact, based on Fannie Mae's recent experience, the purchase of seasoned loans appears to be one useful strategy for purchasing Housing Goals-qualifying loans.

The current low homeownership rate of minorities and others living in inner cities suggests that there will be considerable growth in the origination of CRA loans in urban areas. For banks and thrifts, selling their CRA originations will free up capital to make new CRA loans. As a result, the CRA market segment provides an opportunity for the GSEs to expand their affordable lending programs. As explained in Appendix A, Fannie Mae and Freddie Mac have already started developing programs to purchase CRA-type loans on a flow basis as well as after they have seasoned.

While the GSEs can choose any strategy for leading the market, this leadership role can likely be accomplished by building on the many initiatives and programs that the enterprises have already started, including: (1) Their outreach to underserved markets and their partnership efforts that encourage mainstream lenders to move into these markets; (2) their incorporation of greater flexibility into their purchase and underwriting guidelines, (3) their development of new products for borrowers with little cash for a downpayment and for borrowers with credit blemishes or non-traditional credit histories; (4) their targeting of important markets where they have had only a limited presence in the past, such as the markets for minority first-time homebuyers; (5) their purchases of both newly-originated and seasoned CRA loans; and (6) their use of automated underwriting technology to qualify creditworthy borrowers that would have been deemed not creditworthy under traditional underwriting rules.

The experience of Fannie Mae and Freddie Mac in the subprime market indicates that they have the expertise and experience to develop technologies and new products that allow them to enter new markets in a prudent manner. Given the innovativeness of Fannie Mae and Freddie Mac, other strategies will be available as well. In fact, a wide variety of quantitative and qualitative indicators suggest that the GSEs have the expertise, resources and financial strength to improve their affordable lending performance enough to lead the home purchase market for special affordable, low- and moderate-income, and underserved areas loans. The recent improvement in the affordable lending performance of the GSEs, and particularly Fannie Mae, further demonstrates the GSEs' capacity to lead the home purchase market.

3. Counting of Mortgages for the Home Purchase Subgoals

The Department is proposing to amend § 81.15 to add a new paragraph (i) that would clarify that the procedures in § 81.15 generally govern the counting of home purchase mortgages toward the Home Purchase Subgoals in §§ 81.12, 81.13 and 81.14. The new paragraph provides, however, that the numerator and denominator for purposes of counting performance under the Subgoals are comprised of numbers of home purchase *mortgages* in metropolitan areas, rather than numbers of *dwelling units*. Paragraph (i) also provides that, for purposes of addressing missing data or information for each Subgoal, the procedures in § 81.15(d) shall be implemented using numbers of home purchase mortgages in metropolitan areas and not single-family owner-occupied dwelling units. Finally, the new paragraph provides that where a single home purchase mortgage finances the purchase of two or more owner-occupied units, the mortgage shall count once toward each Subgoal that applies to the GSE's mortgage purchase.

C. Definition of Underserved Area for Rural Areas

The rule proposes to change the definition of ''Underserved Area'' for purposes of determining whether a ''Rural Area'' is an ''Underserved Area.'' The definition of a ''Rural Area'' that is an ''Underserved Area'' would be a census tract, Federal or State American Indian Reservation or tribal or individual trust land, or the balance of a census tract excluding the area within any Federal or State American Indian reservation or tribal or individual trust land, having: (i) A median income at or below 120 percent of the greater of the State non-metropolitan median income or nationwide non-metropolitan median income and a minority population of 30 percent or greater, or (ii) a median income at or below 95 percent of the greater of the State non-metropolitan median income or nationwide non-metropolitan income.

This is essentially the same definition that was established in HUD's Housing Goals 2000 final rule, except that census tracts, rather than counties, are the basic spatial unit for determining whether an area is underserved. Because HUD's proposed amendment would establish uniform standards for determining whether a rural area qualifies as an underserved area, there is no longer any need to distinguish underserved areas located in New England from underserved areas in other areas of the country. For this reason, the Department is proposing to eliminate from the definition of ''Underserved area'' the current distinct regulatory treatment for New England.

D. Adequacy of Borrower Income Data

Accurate measurement of the GSEs' performance under the three Housing Goals depends on the completeness of data on borrower income (or, in the case of non-owner-occupied units, the rent) and property location. As between these two, property location is reported by the GSEs on most of the mortgages they purchase—a less than one percent incidence of missing or incomplete geographical data between 2000 and 2002 for each GSE. The incidence of missing borrower income data has been greater—on the order of several percentage points each year.

One reason for the increase in missing income data is the recent increased use of mortgages for which the borrower is not required to provide income information. For some of these mortgages the borrower presents information on assets but not income because of circumstances that make assets easier to document. Other mortgages are originated entirely on the basis of a credit report, property appraisal, and cash for the downpayment. These mortgages typically require relatively large downpayments and often require a higher interest rate than fully documented mortgages.

The Housing Goals 2000 Final Rule provided that the GSEs may exclude from the denominator owner-occupied units lacking mortgagor income data which are located in low-or moderate-income census tracts, *i.e.*, tracts whose median income is no greater than the median income of the metropolitan area or, for properties located outside of metropolitan areas, the larger of the median incomes of the county or the statewide non-metropolitan area (*see* 24 CFR 81.15(d)).[7]

In view of the increasing use of loans made without obtaining income information from the borrower, there is a question whether HUD's existing counting rules for missing-data

[7] For rental units, the 2000 Housing Goals Final Rule also established counting rules which allow the GSEs to estimate rents or exclude units from the denominator when rent data are missing. *See* 24 CFR 81.15(e)(6)(i) on the rules applicable to multifamily units and 24 CFR 81.15(e)(6)(ii) on the rules for single-familly rental units.

situations are adequately reliable and create no more than a negligible statistical bias in the GSEs' Housing Goals performance figures relative to the values that they would have if complete income data could be obtained, and whether a more precise method for imputing incomes could be employed. In order to inform HUD's consideration of this issue, HUD requests comments from the public on the following question: Would it be desirable for HUD to have a standard, econometrically-based method for imputing the income distribution of mortgages purchased by each GSE that lack income data, based on known characteristics of the loan and the tract? Income distribution information would be needed that shows proportions of units that are in the very-low-income range (below 60 percent of area median), low- but not very-low income (60–80 percent) and moderate income (80–100 percent), to support estimating proportions of missing-data loans for both the Low- and Moderate-Income Housing Goal and the Special Affordable Housing Goal. For example, the mortgage amount as a percentage of average loan amounts in the tract, or home prices in the local market, might be used in the estimation process. Depending on the type of methodology that is developed, such a procedure might be applied on a geographical level from census tracts up to the United States as a whole. In the latter case one national estimate would be created for the proportion of owner-occupied units lacking income data that qualify for each Goal, for each GSE.

E. Possible Changes to GSE Counting Rules

FHEFSSA establishes housing goals for the GSEs' purchases of mortgages for low- and moderate-income families, special affordable housing (very-low income families and low-income families in low-income areas) and families with properties in underserved areas (*see* sections 1332–1334) in order to ensure that the GSEs increase the availability to these borrowers of the lower cost financing available through the GSEs. With increasing frequency, the GSEs have entered into large-scale transactions with lenders involving seasoned mortgages to achieve the housing goals. It is possible that some of these transactions may include broad buyback arrangements with the seller for the transaction.

HUD's rules at 24 CFR 81.2 define a ''mortgage purchase'' to mean a transaction in which a GSE bought or otherwise acquired with cash or other thing of value a mortgage for its portfolio or securitization. HUD counts the GSEs' performance under the Housing Goals pursuant to HUD's counting rules under 24 CFR 81.15 and 81.16. Both the counting rules and definitions are designed to ensure consistency with the statute and its purposes of increasing the availability of financing for homeowners targeted by the Goals.

In light of HUD's interest in ensuring that transactions are appropriately counted under the law and in accordance with its purposes, HUD asks whether the definition of ''mortgage purchase'' in § 81.2 should be revised in the final rule. Should HUD, for example, further define ''transactions in which a GSE bought or otherwise acquired with cash or other thing of value, a mortgage for its portfolio or for securitization'' for purposes of ensuring appropriate counting of large transactions and, if so, how? HUD also asks what changes, if any, to HUD's regulations (including, but not limited to, changes to the counting rules at §§ 81.15 and 81.16) are warranted to ensure that the GSEs' large scale transactions further the requirements and purposes of the Housing Goals. Do commenters believe HUD's current rules are sufficiently specific to determine which seasoned mortgage transactions, including large-scale transactions, are substantially equivalent to mortgage purchases? If commenters believe the rules are not sufficiently specific, how should the rules be changed?

F. Verification and Enforcement of GSE Data Integrity—Revised § 81.102

1. Summary

The Department's ability to monitor effectively the GSEs' performance under the Housing Goals, and otherwise to carry out its regulatory functions, depends in large measure upon the submission of accurate, complete and current data, information and reports by Fannie Mae and Freddie Mac. The GSEs' Charter Acts require Fannie Mae and Freddie Mac to submit data, information and reports on Housing Goals performance under subsections 307(e) and (f) of the Freddie Mac Charter Act and subsections 309(m) and (n) of the Fannie Mae Charter Act. FHEFSSA also requires the GSEs to submit reports (*see* section 1327 of FHEFSSA, 12 U.S.C. 4547), and other authorities necessitate that the GSEs submit information for HUD's review (*see*, for example, section 1325 of FHEFSSA, 12 U.S.C. 4545).

HUD's current GSE regulations at 24 CFR 81.102 make clear that HUD may verify the accuracy and completeness of data, information and reports submitted by the GSEs, but as a practical matter most verification of data, information and reports occurs well after their submission to the Department, which renders this current verification provision a useful but not immediately effective regulatory control. Indeed, in the case of data and information needed to calculate Housing Goals performance, verification occurs only after such Housing Goals performance has been calculated. Likewise, the information provided in reports ordinarily would not be verified until well after the report is submitted.

For these reasons, the Department has concluded that, to ensure the integrity of the report(s), data submission(s) and other information provided to the Department, additional measures are necessary. Accordingly, as described more fully below, the Department is proposing to revise § 81.102 to: (1) Re-codify in paragraph (a) the existing authority under § 81.102 which authorizes HUD to independently verify the accuracy and completeness of data, information and reports provided by the GSEs; (2) establish in paragraph (b) certification requirements for the submission of the GSEs' Annual Housing Activities Report (AHAR) and for such other report(s), data submission(s) or information for which certification is requested in writing by HUD; (3) codify in paragraph (c) HUD's process for handling errors, omissions or discrepancies in the GSEs' current year-end data submissions (including the AHAR); (4) clarify in paragraph (d) that HUD may exercise its Housing Goal counting authority by adjusting Goals performance for a current year by deducting miscredits from a previous year caused by errors, omissions or discrepancies in a GSE's prior year data submissions (including the AHAR); and (5) clarify in paragraph (e) that HUD may take enforcement action against the GSEs under section 1341 of FHEFSSA (12 U.S.C. 4581) and section 1345 of FHEFSSA (12 U.S.C. 4585), as implemented by subpart G (''Procedures for Actions and Review of Actions'') of HUD's regulations at 24 CFR part 81 for the submission of non-current, inaccurate or incomplete information or data.

2. Background

Under section 1336 of FHEFSSA (12 U.S.C. 4566), HUD is required to monitor and enforce compliance with the Housing Goals. The GSEs each submit quarterly information and semi-annual loan-level data on their mortgage purchases pursuant to their Charters and the requirements of 24 CFR part 81. To fulfill its monitoring responsibility, HUD conducts two types of verification procedures for this data and information.

The first procedure is a recalculation process whereby HUD, using the loan-level data provided by the GSEs, reconstructs each GSE's Housing Goals performance for the reporting period by applying current counting rules and Housing Goal eligibility criteria to the data provided. These recalculations are conducted immediately upon receipt of the GSEs' loan-level data. If adjustments in performance data are necessary because a GSE has improperly applied counting rules, or HUD discovers some other error during the recalculation process, the Department makes these adjustments at the time recalculation work is done and calculates the GSE's official Housing Goals performance based on the adjustment. HUD publishes the GSEs' official Housing Goal performance figures for the year on its Web site, usually within six months of the end of the reporting year, and includes these figures in other published HUD management and performance reports.

The second type of verification procedure consists of performance reviews, including audit procedures, which occur after the reporting year is closed and Housing Goal results have been announced. Performance reviews evaluate the GSEs' internal controls and related business practices relative to the accuracy, completeness, and appropriateness of the information and data that were provided to HUD and upon which Housing Goals performance was based. These reviews also include sampling tests of source documents and data testing to determine the accuracy of reported data and to review the transactions a GSE relied upon to develop the data. Due to the timing of these reviews, which can begin no earlier than the close of a reporting year, and the extensive sampling work involved, it may take up to 24 months from the date of the report under review for HUD to develop its findings on a reporting year.

3. Independent Verification Authority—§ 81.102(a)

As indicated, the Department is first proposing to recodify existing § 81.102 as paragraph (a) in the revised § 81.102. Paragraph (a) would retain HUD's current regulatory authority to independently verify the accuracy and completeness of data, information and reports submitted by a GSE, thereby retaining the Department's authority to conduct on-site verifications, and to carry out performance reviews.

As the Department noted in the preamble to its Housing Goals 1995 final rule, the authority to verify information is derived in part from section 1321 of FHEFSSA (12 U.S.C. 4541), which accords the Secretary ''general regulatory power over each enterprise.'' The Secretary's general regulatory power is in addition to the enumerated powers conferred on the Secretary by FHEFSSA and the GSEs' Charter Acts. The Department also regards verification authority as necessary and incidental to its authority under section 1336 of FHEFSSA to monitor and enforce compliance with the Housing Goals.

Accordingly, the rule would retain in paragraph (a) of § 81.102 its existing regulatory authority to independently verify the accuracy and completeness of data, information and reports submitted by a GSE.

4. Certification—§ 81.102(b)

The Department is proposing in this rule to require the GSEs to provide a certification in connection with their AHARs submitted under sections 309 (m) and (n) of the Fannie Mae Charter Act or section 307(e) and (f) of the Freddie Mac Charter Act, as applicable, that, among other things, the AHAR is current, complete and does not contain any untrue statement of a material fact as detailed below. The rule would also make clear that the Department could require such certification for such other report(s), data submission(s) or information for which certification is requested in writing by HUD.

Because of the post facto nature of performance reviews, such reviews cannot be the sole means of preventing the submission of incorrect data. HUD believes that certification requirements better serve the end of assuring the integrity of data, information and report(s) (including the AHAR) submitted at the outset and such requirements are consistent with current practice.

Pursuant to its regulatory authority, HUD has in the past, with regard to certain specific matters, required that Fannie Mae and Freddie Mac certify the accuracy, currency and completeness of information and data submitted to the Department. Other financial regulators, such as the Office of Federal Housing Enterprise Oversight (OFHEO), the Securities and Exchange Commission (SEC), and the Federal Deposit Insurance Corporation (FDIC) require similar certifications to ensure the accuracy of information submitted to them. Similarly as the GSEs register their stock with the SEC, they will be required to certify financial statements and other information submitted to the SEC. Moreover, the recently enacted Sarbanes-Oxley Act of 2002 (P.L. 107–204, approved July 30, 2002) requires certification as a means of ensuring corporate accuracy in, and accountability for, the financial information provided by a corporation to its regulators and to the public (*see* 15 U.S.C. 7241).

The Department's proposal requiring the GSEs to submit a certification in connection with their AHARs and such other report(s), data submission(s) or information for which certification is requested in writing by the Department, is reasonably related to the Department's performance of its statutory duties under FHEFSSA and is well supported by both statutory and regulatory authority.

Specifically, as stated, section 1321 of FHEFSSA grants the Secretary ''general regulatory power'' over the GSEs and directs the Secretary to ''make such rules and regulations as shall be necessary and proper'' to carry out the purposes of FHEFSSA and the GSEs' Charter Acts. The Supreme Court has repeatedly held that a grant to an agency of ''general regulatory authority'' extends to the agency those unenumerated powers that are ''reasonably related to the purposes of the enabling legislation.'' (*See Mourning* v. *Family Publications Service, Inc.*, 411 U.S. 356, 369 (1973) (quoting *Thorpe* v. *Housing Authority of City of Durham*, 393 U.S. 268, 280–281 (1969).) This standard has been accepted by every Federal Court of Appeals. (*See, e.g., Action on Smoking and Health* v. *CAB*, 699 F.2d 1209, 1212 (D.C. Cir. 1983).)

Moreover, under section 1336 of FHEFSSA, the Secretary is expressly mandated by Congress to ''monitor and enforce [the GSEs'] compliance with the housing goals established under * * * [FHEFSSA]'' and the GSEs' Charter Acts require the GSEs to submit a report to designated Congressional committees and to the Secretary ''on [their] activities under subpart B of * * * [FHEFSSA].'' (*See* section 309(n) of the Fannie Mae Charter Act, 12 U.S.C. 1723a(n); section 307(f) of the Freddie Mac Charter Act, 12 U.S.C.1456(f).) Also, section 309(n)(2)(L) of the Fannie Mae Charter Act and section 307(f)(2)(L) of the Freddie Mac Charter Act expressly grant the Secretary the discretion to require the GSEs to submit in their AHARs ''*any other information that the Secretary considers appropriate*'' with respect to their activities under subpart B of FHEFSSA. (Emphasis added.)

The Secretary also is accorded by statute a number of fact finding functions. These include the authority to require reports (see section 1327 of FHEFSSA), to gather data from the GSEs on their mortgage purchases (see sections 309(m) and (n) of the Fannie Mae Charter Act and sections 307(e) and (f) of the Freddie Mac Charter Act), to monitor and enforce compliance with the housing goals (see section 1336 of FHEFSSA), and to issue subpoenas (see section 1348 of FHEFSSA). These functions in turn permit the Secretary to make factual determinations, such as: (1) Whether a GSE is complying with the Housing Goals; (2) whether a GSE has made a good-faith effort to comply with a housing plan; and (3) whether a GSE has submitted the mortgage information and reports required under sections 309(m) and (n) of the Fannie Mae Charter Act, sections 307(e) and (f) of the Freddie Mac Charter Act and section 1327 of FHEFSSA. The Secretary also is charged with the authority to initiate enforcement actions upon determining that the law has been violated.

Since all of these functions necessitate the submission of current, complete and accurate information, data and reports, a certification requirement is necessary to carrying out these functions.

For these reasons, the Department is proposing to amend § 81.102 by adding a new paragraph (b) that requires the GSE senior officer responsible for submitting to HUD the AHAR and such other report(s), data submission(s) or information for which a certification is requested in writing by HUD (referred to in the rule as the ''GSE Certifying Official'') to submit a certification in connection with such documents.

The rule would require that the GSE certification provide: (1) The GSE Certifying Official has reviewed the particular AHAR, other report(s), data submission(s) or information; (2) to the best of the GSE Certifying Official's knowledge and belief, the particular AHAR, other report(s), data submission(s) or information are current, complete and do not contain any untrue statement of a material fact; (3) to the best of the GSE Certifying Official's knowledge and belief, the AHAR or other report(s), data submission(s) and information fairly present in all material respects the GSE's performance, as required to be reported by section 309(m) or (n) of the Fannie Mae Act, section 307(e) or (f) of the Freddie Mac Charter Act, or other applicable legal authority; and (4) to the best of the GSE Certifying Official's knowledge and belief, the GSE has identified in writing any areas in which the GSE's particular AHAR, other report(s), data submission(s) or information may differ from HUD's written articulations of its counting rules including, but not limited to, the regulations under 24 CFR part 81, and any other areas of ambiguity.

5. Adjustment To Correct Current Year-End Errors, Omissions or Discrepancies—§ 81.102(c)

The Department is proposing to add a new paragraph (c) to § 81.102 that would largely codify its administrative practice regarding errors, omissions or discrepancies it discovers relative to HUD's regulations and/or other guidance concerning how current year data are reported by a GSE and provide the GSEs with a mechanism upon which to comment.

Under this paragraph, the Department is proposing to notify the GSE initially by telephone or e-mail transmission of errors, omissions or discrepancies in current year-end data reporting relative to HUD's regulations and other guidance. The GSE has five business days to respond to such notification. If each error, omission or discrepancy is not resolved to the Department's satisfaction, HUD will then notify the GSE in writing and seek clarification or additional information to correct the error, omission or discrepancy. The GSE will have 10 business days from the date of HUD's written notice to respond in writing to the request (or such longer time as HUD may establish, not to exceed 30 business days). If the GSE fails to submit a written response to HUD within the 10-day (or longer) time period, or if HUD determines that the GSE's written response fails to explain or correct the error, omission or discrepancy in its current year-end reported data submissions (including the AHAR) to HUD's satisfaction, the Department will determine the appropriate adjustments to the numerator and the denominator to calculate performance under the applicable Housing Goal(s) and/or Subgoal(s). The Department's determination may involve excluding the unit(s) or mortgage(s) from the numerator and including them in the denominator of the applicable Housing Goal(s) and/or Subgoal(s). The Department may also pursue additional enforcement actions against the GSE under § 81.102(e), if it determines that such action is warranted.

The Department's legal authority to implement this provision also is based upon its general regulatory power over each enterprise pursuant to section 1321 of FHEFSSA and its explicit statutory authority under section 1336 of FHEFSSA to monitor and enforce the GSE's compliance with the Housing Goals. In addition, this provision is predicated upon the Department's existing regulatory authority under 24 CFR 81.102 to independently verify the accuracy and completeness of data, information and reports submitted by a GSE.

6. Adjustment To Correct Prior Year Reporting Errors—§ 81.102(d)

The Department is proposing to add a new paragraph (d) to § 81.102 that would provide for effective regulatory oversight and enforcement when it determines that a GSE has, in a prior year, improperly calculated its performance under one or more Housing Goals and/or Subgoals as a result of errors, omissions or discrepancies in its data submissions (including its AHAR).

As background for this proposal, notably unlike financial reporting where results are cumulative from year to year and the results of adjustments in prior years carry forward to the current year, the GSEs' Housing Goal performance reports (the Annual Housing Activity Reports) impact only the current reporting year. This means that, unlike financial reporting, if corrections are not made prior to release of HUD's official performance data for the reporting year, any subsequent corrections to that data for that year are likely to go unnoticed by the public and policy makers.

In addition, if a correction is such that it would have caused failure under a Housing Goal that was previously reported as having been achieved, HUD's enforcement remedies under section 1336 of FHEFSSA would have little relevance as they only require a GSE to submit a housing plan to ensure compliance with the Housing Goals in the current or subsequent calendar year.

For these reasons, it is not practical to correct overstatements in performance data that were reported in previous years by adjusting performance for a prior year. On the other hand, adjustments to current year performance are an effective means of assuring accuracy in counting under the Housing Goals in a manner that makes the public aware of the adjustment. Accordingly, the Department is proposing to add a new paragraph (d) to § 81.102 that would enable it to reduce a GSE's current year credit toward its Housing Goals performance based on errors, omissions or discrepancies that the Department discovers in a GSE's prior year's data submissions (including its AHAR).

This procedure, to be known as an ''adjustment to correct prior year reporting errors, omissions or discrepancies,'' would provide the

Department with a mechanism for ensuring the continued accuracy, completeness and currency of each GSE's performance results. The Department anticipates that the procedure would be used infrequently. Even so, given the increasing complexity of each GSE's business as well as the complexity of many of the transactions that the GSEs use to meet their Housing Goals, the Department believes that the proposed procedure is both reasonable and necessary. Should its use become necessary, the proposed procedure will provide a means for HUD to effect corrections in a manner that is appropriate and obvious to those who track the GSEs' performance annually, and it will help to ensure that the GSEs continue to exercise appropriate diligence in their Housing Goals reporting.

The Department's proposed procedure would provide that the Department may adjust a GSE's current year Housing Goal performance to correct for any overstatement in Housing Goals reporting discovered in the course of performance reviews or otherwise of any previous year's Annual Housing Activity Report that were the result of errors, omissions or discrepancies. Should the Department determine that an adjustment to current year data for a prior year error, omission or discrepancy in Housing Goal reporting is warranted, the Department would communicate its initial findings and determinations in writing to the GSE within 24 months of the end of the relevant reporting year. The GSE would have 30 days from the date of HUD's initial letter to respond in writing, with supporting documentation, to contest the determination. Within 60 days of the date of the GSE's written response, the Department would issue a final determination letter to the GSE (unless HUD determines that good cause exists to extend this period for an additional 30 days.)

If the GSE fails to submit a written response to HUD within the 30-day period, or if the Department otherwise determines that an adjustment is warranted, the GSE would be required to reflect an adjustment in its Annual Housing Activity Report for the current year, as directed by HUD. The adjustment would be reflected in the GSE's year-end performance under the applicable Housing Goal(s) or Subgoal(s) for the current reporting year by deducting the number of units or mortgages that HUD has determined were erroneously counted in a previous year from the numerator (but not the denominator) for the relevant Housing Goal or Subgoal.

The Department proposes that this provision will become effective upon publication of the final rule for reporting periods occurring on or after the rule's effective date. It will not be retroactive to reporting periods that preceded publication of the final rule. Should any adjustment cause a failure under a Housing Goal in the current year, then current year Housing Goals performance would be subject to enforcement under sections 1336, 1341, and 1345 of FHEFSSA, and subpart G of part 81.

As noted, section 1321 of FHEFSSA grants the Secretary ''general regulatory power over each enterprise'' which includes the authority to ''make such rules and regulations as shall be necessary and proper to ensure that [Part 2, Subtitle A, of FHEFSSA] and the purposes of [the GSEs' Charter Acts] are accomplished.'' The Secretary's general regulatory power under section 1321 is in addition to the specific enumerated powers conferred on the Secretary by FHEFSSA and the GSEs' Charter Acts.

Moreover, also as noted, section 1336 of FHEFSSA—under which the Secretary is mandated by Congress to ''monitor and enforce compliance with the housing goals established under sections 1332, 1333, and 1334, as provided in this section * * *''—expressly authorizes HUD to establish guidelines to measure the extent of compliance with the Housing Goals. Section 1336 further authorizes HUD to ''assign full credit, partial credit, or no credit toward achievement of the Housing Goals to different categories of mortgage purchase activities of the enterprises, *based on such criteria as the Secretary deems appropriate.*'' (Emphasis added.)

The Department's proposal to grant only partial credit to a GSE in its current year performance report to correct for a prior year's error constitutes an appropriate counting criterion to assure the accuracy of data used to assess GSE performance under the Housing Goals.

7. Additional Enforcement Provisions—§ 81.102(e)

Finally, the rule would make clear that a GSE's submission of data, information, or reports required by section 307(e) or (f) of the Freddie Mac Charter Act, section 309(m) or (n) of the Fannie Mae Charter Act or subpart E of part 81 that are incomplete, not current, or contain an untrue statement of material fact shall be regarded by the Department as equivalent to failing to submit such data, information or reports. For such a non-submission, the Department may bring under subpart G of part 81 an order to cease and desist and/or to levy civil money penalties in connection with a GSE's failure to comply with its statutory obligations under its Charter Act and FHEFSSA.

III. Discussion of Proposed Regulatory Changes

A. Subpart A—General

Section 81.2—Definitions

The proposed regulation would change several current definitions in § 81.2, and add a new definition to this section. First, to conform HUD's regulations to changes in data collection practices made by the Office of Management and Budget (OMB), HUD's proposed regulation would change the current definitions of ''Metropolitan area'' and ''Minority.'' Second, the proposed regulation would modify the current definition of ''Underserved area.'' Finally, the proposed regulation would add a new definition for ''Home Purchase Mortgage'' consistent with this proposal.

''Metropolitan area''—The proposed regulation would change the current definition of ''metropolitan area'' to remove the term ''primary metropolitan statistical area (''PMSA'')'' since this is a term that is no longer used by the Office of Management and Budget (OMB) in defining ''metropolitan area.'' *See* Office of Management and Budget, *Standards for Defining Metropolitan and Micropolitan Statistical Areas,* 65 FR 82228–82238 (December 27, 2000).

''Minority''—The proposed regulation would also change the definition of the term ''minority'' in light of significant changes in reporting conventions for race and ethnicity, in accordance with OMB guidance.

Currently, ''minority'' is defined in HUD regulations as ''any individual who is included within *any one*'' of the following list of racial and ethnic categories (emphasis added). The proposed regulation would change the definition of minority to ''any individual who is included within any one *or more*'' of the following list of racial and ethnic categories (emphasis added). This change is consistent with a decision made by OMB in 1997, revising federal data classification standards on race and ethnicity, to allow individuals, in federal data collection, to identify themselves in more than one category. *See* Office of Management and Budget, *Revisions to the Standards for the Classification of Federal Data on Race and Ethnicity,* 62 FR 58781–58790 (October 30, 1997).

Also, consistent with OMB determinations, the proposed regulation would change the current definition of ''minority'' so that: (1) ''American

Indian'' would be defined to include persons with origins in any of the original peoples of South and Central America; (2) ''Asian or Pacific Islander'' would be divided into separate categories—''Asian,'' which would include examples of countries of origin, and ''Pacific Islander'' which would be included in a new definition with ''Native Hawaiian'' (which would include ''peoples having origins in any of the original peoples of Hawaii, Guam, Samoa, or other Pacific Islands;'' (3) ''African-American'' would be changed to ''Black or African American;'' and (4) ''Hispanic'' would be changed to ''Hispanic or Latino.''

''Underserved area''—As discussed more fully above (*see* section II.C), the proposed regulation would change the definition of ''Underserved area'' for purposes of determining whether a ''Rural area'' is an underserved area.

''Home Purchase Mortgage''—Consistent with the proposed establishment of Home Purchase Subgoals, the proposed regulation would add a definition for ''Home Purchase Mortgage,'' which would be defined to mean a residential mortgage for the purchase of an owner-occupied single-family property.

B. Subpart B—Housing Goals

1. Background

The Department is required to establish, by regulation, annual Housing Goals for each GSE. The Goals include a Low- and Moderate-Income Housing Goal, a Special Affordable Housing Goal, and a Central Cities, Rural Areas, and Other Underserved Areas Housing Goal (the Underserved Areas Housing Goal). Section 1331(a) of FHEFSSA requires HUD to establish these Goals in a manner consistent with sections 301(3) of the Fannie Mae Charter Act and 301(b)(3) of the Freddie Mac Charter Act, which require the GSEs ''to provide ongoing assistance to the secondary market for residential mortgages (including * * * mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities).'' Under section 1331(c) of FHEFSSA, HUD may, by regulation, adjust any Housing Goal from year to year.

In October 2000, HUD established Housing Goals for the GSEs for 2001–2003, revising and restructuring the Goals that had been in effect for 1996–2000. The current Housing Goal levels, which were in place for 2001–2003 and extended through 2004 without the bonus points and Temporary Adjustment Factor, are:

- A Low- and Moderate-Income Housing Goal, which focuses on mortgages on housing for families with incomes no greater than area median income (as defined by HUD),[8] and which is set at 50 percent of total units financed by each of the GSEs' mortgage purchases;
- An Underserved Areas Housing Goal, which focuses on mortgages on properties located in ''underserved areas,'' defined as low-income and/or high-minority census tracts and rural counties (excluding high-income, high-minority tracts), and which is set at 31 percent of total units financed by each of the GSEs' mortgage purchases in 2001–2004;
- A Special Affordable Housing Goal, which focuses on mortgages on housing for very low-income families and low-income families living in low-income areas, and which is set at 20 percent of total units financed by each of the GSEs' mortgage purchases in 2001–2004; and
- A Special Affordable Multifamily Subgoal, which focuses on mortgages on housing for very low-income families and low-income families living in low-income areas, in multifamily properties (defined as properties with five or more units), and which is set at a fixed amount of 1.0 percent of the average total dollar volume of mortgages purchased by each GSE in the years 1997, 1998, and 1999. This formula results in a Subgoal of special affordable multifamily mortgage purchases totaling $2.85 billion per year for Fannie Mae and $2.11 billion per year for Freddie Mac for each calendar year from 2001 through 2004.

These Housing Goals, excluding the Special Affordable Multifamily Subgoal, share common characteristics: (1) The Goal levels are the same for both GSEs; (2) they are percentage based Goals defined in terms of percentages of housing units financed; and (3) one unit may qualify for one or more Goals. In addition, under the current regulation, Goals were established based on consideration of the statutory factors and set for a three-year period from 2001 through 2003 to allow the GSEs time to develop long-range strategies.

A key factor in determining the level of the Goals was and is the estimated size of the conventional market for each Goal. This determination is discussed above and in Appendix D. HUD estimates that the low- and moderate-income market accounted for 54–59 percent of all mortgages originated during the 1997 to 2002 period, and for 54–55 percent in 2001 and 2002. The special affordable market accounted for 26–30 percent for 1997–2002, and 26–27 percent for 2001–2002. The underserved areas market defined in terms of 1990 Census data and pre-2003 metropolitan area boundaries accounted for 31–35 percent for 1997–2002 and 32–33 percent for 2001–2002. With 2000 Census data and the metropolitan area boundaries established in June, 2003, these figures become 37–40 percent for 1999–2002 and 37–39 percent for 2001–2002.

In accordance with FHEFSSA, HUD has re-estimated the market shares of the mortgages in the primary conventional market that would qualify for each of the GSEs' Housing Goals for the years 2005 through 2008.[9] HUD estimates that for the years 2005 through 2008 the low- and moderate-income share of the conventional market will be 51–57 percent, the underserved areas share of the market will be 35–40 percent, and the special affordable share will be 24–28 percent. Appendix D, ''Estimating the Size of the Conventional Conforming Market for Each Housing Goal,'' provides an extensive analysis of the Department's market share estimates.

The gaps between the current Goal levels and HUD's latest market estimates indicate that the Goals should be higher and that there are ample opportunities available for the GSEs to meet the new initial Goals in 2005 as they institute measures to ensure that they will attain the increased goal levels in 2006–2008. Moreover, HUD's new market estimates allow for more adverse economic and affordability conditions than recently experienced. For example, the lower end—51 percent—of the range for the low- and moderate-income market estimate is consistent with low- and moderate-income borrowers accounting for 38 percent of home purchase loans in the single-family owner-occupied market. (The remainder of the low- and moderate-income market share estimate includes multifamily and single-family rental properties.) Since the 1995–2002 average for the low- and moderate-income share of the home purchase market was 43.5 percent, and the more recent 1999–2002 average was 44.6 percent, the initial Goals for 2005 allow leeway for more adverse income and interest rate conditions.

[8] 24 CFR 81.2.

[9] The Goal-qualifying market shares are estimated for the years 2005–2008 under several projections about the relative sizes of the single-family and multifamily markets. Numerous sensitivity analyses that consider alternative market and economic conditions are examined in Appendix D.

2. Low- and Moderate-Income Housing Goal, § 81.12

This section discusses the Department's consideration of the statutory factors in arriving at the new Housing Goal level for the Low- and Moderate-Income Housing Goal, which targets mortgages on housing for families with incomes at or below the area median income. After analyzing the statutory factors, this proposed rule would establish (a) a Goal of 52 percent for the percentage of the total number of dwelling units financed by each GSE's mortgage purchases for housing affordable to low- and moderate-income families for 2005, rising to 53 percent in 2006, 55 percent in 2007, and 57 percent in 2008, and (b) a Subgoal of 45 percent of the total number of owner-occupied dwelling units financed by each GSE's purchases of home purchase mortgages in metropolitan areas that are for housing affordable to low- and moderate-income families for 2005, rising to 46 percent in 2006, 47 percent in 2007, and 47 percent in 2008.

A short discussion of the statutory factors reviewed to establish the Goal follows. More detailed information analyzing each of the statutory factors is provided in Appendix A, ''Departmental Considerations to Establish the Low- and Moderate-Income Housing Goal,'' and Appendix D, ''Estimating the Size of the Conventional Conforming Market for each Housing Goal.''

a. Market Estimate for the Low- and Moderate-Income Housing Goal

The Department estimates that dwelling units serving low- and moderate-income families will account for 51–57 percent of total units financed in the overall conventional conforming mortgage market during the period 2005 through 2008. HUD has developed this range, rather than a specific point estimate, to account for the projected effects of different economic and affordability conditions that can reasonably be anticipated. HUD estimates that low- and moderate-income share of the market averaged 57 percent between 1999 and 2002.

b. Past Performance of the GSEs under the Low- and Moderate-Income Housing Goal

As discussed above, a number of changes in Goal-counting procedures were adopted as part of HUD's Housing Goals 2000 final rule. Thus, it is necessary to provide information using several different measures in order to track performance on the Low- and Moderate-Income Housing Goal over the 1996–2002 period. Table 3 shows performance under these measures.

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Table 3

GSE Performance on the Low- and Moderate-Income Housing Goal, 1996-2002, and Proposed Goals for 2005-08

								2005-08 Proposed Goals			
	1996	1997	1998	1999	2000	2001*	2002*	2005	2006	2007	2008
Goal Levels: Actual	40%	42%	42%	42%	42%	50%	50%				
Proposed								**52%**	**53%**	**55%**	**57%**
Fannie Mae Goal Performance											
Official	45.6%	45.7%	44.1%	45.9%	49.5%	51.5%	51.8%				
2001-03 Baseline**	46.8%	47.5%	45.1%	46.8%	51.3%	49.2%	49.0%				
With 2005 Assumptions***				**46.3%**	**51.2%**	**48.7%**	**47.9%**				
Freddie Mac Goal Performance											
Official	41.1%	42.6%	42.9%	46.1%	49.9%	53.2%	51.4%				
2001-03 Baseline**	41.2%	42.7%	43.2%	46.6%	50.6%	47.7%	46.5%				
With 2005 Assumptions***				**46.0%**	**50.2%**	**47.0%**	**45.0%**				

* Goal level and official performance in 2001-03 are not directly comparable with goal level and performance in 1996-2000, because the goal performance counting rules for 2001-03 differ from those that were in effect for 1996-2000, as discussed in the text. Goal performance is based on official HUD results.

** "2001-03 Baseline" represents performance under current scoring rules (which exclude bonus points and Freddie Mac temporary adjustment factor), without any use of 2000 census data in estimating area median incomes; census tract boundaries as of the 1990 census; and metropolitan area boundaries prior to their re-specification by the Office of Management and Budget in June, 2003.

*** "2005 Assumptions" represents performance under current scoring rules (which are proposed to continue for 2005-2008) with 2000 census data used in estimating area median incomes; census tract boundaries as of the 2000 census; and the Office of Management and Budget's specification of metropolitan area boundaries as of June, 2003.

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Specifically, the following changes were made in counting procedures for measuring performance on the Low- and Moderate-Income Housing Goal for 2001–03. HUD:

(a) Established ''Bonus points'' (awarding double credit) for purchases of low- and moderate-income mortgages on small (5–50 unit) multifamily properties and, above a threshold level, mortgages on 2–4 unit owner-occupied properties;

(b) Established a ''temporary adjustment factor'' (1.35 units credit, as revised by Congress for 2001–03 from HUD's 1.2 unit credits in the 2000 rule) that applied to Freddie Mac's purchases (but not Fannie Mae's purchases) of low- and moderate-income mortgages on large (more than 50-unit) multifamily properties; and

(c) Revised procedures that HUD had instituted regarding the treatment of missing data on unit affordability, the use of imputed or proxy rents for determining Goal credit for multifamily mortgages, and the eligibility for Goals credit for certain qualifying government-backed loans.

Based on the counting rules in effect at that time for 1996–2000, as shown under ''official performance'' for 1996–2000 in Table 3, Low- and Moderate-Income Housing Goal performance for Fannie Mae was consistently in the 44–46 percent range over the 1996–1999 period, before jumping to a peak of 49.5 percent in 2000. Freddie Mac's performance started at a lower level, but then increased in several steps, from 41–43 percent in 1996–98 to 46.1 percent in 1999, and a record level of 49.9 percent in 2000. That was the only year prior to 2001 in which Freddie Mac's performance has exceeded Fannie Mae's performance on this Goal.

Based on the then current counting rules, including the bonus points and TAF, as shown under ''official performance'' in Table 3, Low- and Moderate-Income Housing Goal performance in 2001 was 51.5 percent for Fannie Mae and 53.2 percent for Freddie Mac. Low- and Moderate-Income Housing Goal performance in 2002 was 51.8 percent for Fannie Mae and 51.4 percent for Freddie Mac.

Immediately beneath the official Low- and Moderate-Income Housing Goal performance percentages in Table 3 are figures showing the GSEs' low- and moderate-income purchase percentages on a consistent basis for the entire 1996–2002 period. The assumptions used were the scoring rules established in HUD's Housing Goals 2000 Final Rule except that bonus points and the Freddie Mac Temporary Adjustment Factor (which were terminated at the end of 2003) are not applied. These figures are termed the ''2001–03 baseline assumptions.'' For 1996–2000 these figures differ from the official performance figures because they incorporate the revised counting procedures described under point (c), above, which were not reflected in the official performance figures at that time. For 2001 and 2002 both sets of figures incorporate the revised counting procedures, but the baseline does not incorporate the bonus points and the Freddie Mac Temporary Adjustment Factor.

In terms of the 2001–2003 baseline measure, both Fannie Mae and Freddie Mac's low- and moderate-income performance reached its maximum in 2000 (Fannie Mae at 51.3 percent and Freddie Mac at 50.6 percent) before declining somewhat in 2001 and 2002. Both GSEs' baseline performance in 2001 exceeded the level attained in 1999. However, Freddie Mac's baseline performance fell further in 2002, to approximately the same level as in 1999. Fannie Mae's baseline performance was essentially unchanged in 2002.

Overall, both GSEs' performance exceeded HUD's Low- and Moderate-Income Housing Goals by significant margins in 1996–99, and by wide margins in 2000. New, higher Goals were established for 2001–03, and despite somewhat lower performance than the level attained in 2000, both GSEs' official performance exceeded the new goal levels in 2001 and 2002, with the inclusion of the bonus points and the TAF.

The decline in baseline performance in 2001 and 2002 can be attributed in large measure to the mortgage refinance wave that occurred in those years. Fannie Mae's overall volume of mortgage purchases (in terms of numbers of housing units) rose from 2.2 million in 2000 to 4.7 million in 2001, and then to 6.0 million in 2002. Similarly, Freddie Mac's volume rose from 1.6 million in 2000 to 3.3 million in 2001, and then to 4.3 million in 2002. For each GSE the increase in volume each year can be largely attributed to increases in purchase volumes for refinance mortgages relative to home purchase mortgages. For each GSE, the fraction of mortgages that qualified as Low- and Moderate-Income was less for refinance mortgages than for home purchase mortgages.

For 2005–2008 HUD does not propose to change the current procedures regarding the treatment of missing data on unit affordability, the use of imputed or proxy rents for determining Goal credit for multifamily mortgages, or the eligibility for Goal credit of certain qualifying government-backed loans. That is, the Department does not plan to change the 2001–03 baseline assumptions for scoring loans under the Low- and Moderate-Income Housing Goal.

Beneath the 2001–03 baseline figures in Table 3 is another row of figures designated ''With 2005 Assumptions.'' These figures show the effects of applying 2000 Census data and the new specification of Metropolitan Statistical Areas released by the Office of Management and Budget in 2003 to the measurement of Low- and Moderate-Income purchase percentages with the same counting rules that were used for the 2001–03 baseline. The effect is to reduce the Goal-qualifying percentage by an average of 0.5 percentage points for Fannie Mae and 0.8 percentage points for Freddie Mac, over the four-year period.

c. Proposed Low- and Moderate-Income Home Purchase Subgoal for 2005–2008

The Department proposes to establish a Subgoal of 45 percent of each GSE's purchases of home purchase mortgages on single-family owner-occupied properties in metropolitan areas which are for low- and moderate-income families in 2005, with this Subgoal rising to 46 percent in 2006 and 47 percent in both 2007 and 2008. The purpose of this Subgoal is to encourage the GSEs to increase their acquisitions of home purchase loans for low- and moderate-income families, many of whom are expected to enter the homeownership market over the next few years. If the GSEs meet this Subgoal, in 2005 they will be leading the primary market by approximately one percentage point, based on the income characteristics of home purchase loans reported in HMDA. Between 1999 and 2002, HMDA data show that low- and moderate-income families accounted for an average of 44.3 percent of single-family-owner loans originated in the conventional conforming market of metropolitan areas. Loans in the B&C portion of the subprime market are not included in these averages. To reach the 45-percent Subgoal for 2005, both GSEs must improve their average performance, as shown in Table 2—Fannie Mae by about one percentage point over its average performance of 44.2 percent during 2001 and 2002, and Freddie Mac by 2.4 percentage points over its average performance of 42.6 percent; these required improvements will increase further by one percentage point in 2006 and an additional one percentage point in 2007–08 under HUD's proposal.

As explained above, HUD will be re-benchmarking its median incomes for metropolitan areas and non-metropolitan counties based on 2000 Census median incomes, and will be incorporating the effects of the new OMB metropolitan area definitions. HUD projected the effects of these two changes on the low- and moderate-income shares of the single-family-owner market for the years 1999–2002. These estimates will be referred to as ''projected data'' while the 1990-based data reported above will be referred to as ''historical data.'' The average low-mod share of the home purchase market (without B&C loans) was 43.1 percent based on projected data, as compared with 44.3 percent based on historical data. Thus, based on projected data, the proposed 45-percent Home Purchase Subgoal for 2005 is approximately two percentage points above the 1999–2002 market average. Fannie Mae's average low-mod performance between 1999 and 2002 based on the projected data was 41.4 percent, compared with 42.5 percent based on historical data. To reach the 45-percent Subgoal based on projected data, Fannie Mae would have to improve its performance in 2005 by 2.3 percentage points over its projected average performance of 42.7 percent in 2001 and 2002, or by 1.4 percentage points over its projected 2002 low-mod performance of 43.6 percent. Freddie Mac's average low-mod performance between 1999 and 2002 based on the projected data was 40.9 percent, compared with 42.3 percent based on historical data. To reach the 45-percent Subgoal based on projected data, Freddie Mac would have to improve its performance in 2005 by 4.0 percentage points over its projected average performance of 41.0 percent in 2001 and 2002, or by 2.9 percentage points over its projected 2002 low-mod performance of 42.1 percent.

Section II.B.2 of this preamble and Section I of Appendix A discuss the reasons why the Department is establishing the Subgoal for low- and moderate-income loans, as follows: (1) The GSEs' have the resources and the ability to lead the market in providing mortgage funding for low- and moderate-income families; (2) the GSEs have generally not led the market, even though they have the ability to do so; (3) troublesome disparities in our housing and mortgage markets indicate a continuing need for increased GSE activity; and (4) there are ample opportunities for the GSEs to improve their low- and moderate-income performance in the home purchase market. Although single-family-owner mortgages comprise the ''bread-and-butter'' of their business, the GSEs have historically lagged behind the primary market in financing mortgages for low- and moderate-income families. Because home purchase loans account for a major share of the GSEs' purchases, the establishment of this Subgoal will aid their performance under the overall Low- and Moderate-Income Housing Goal.

For the foregoing reasons, the Department believes that the GSEs can do more to raise the share of their home loan purchases serving low- and moderate-income families. This can be accomplished by building on efforts that the enterprises have already started, including their new affordable lending products, their many partnership efforts, their outreach to inner city neighborhoods, their incorporation of greater flexibility into their underwriting guidelines, and their purchases of seasoned CRA loans. A wide variety of quantitative and qualitative indicators indicate that the GSEs' have the resources and financial strength to improve their affordable lending performance enough to lead the market serving low- and moderate-income families.

d. Proposed Goal Levels for 2005–2008

The Department is proposing to increase the Low- and Moderate-Income Housing Goal to 52 percent for 2005, 53 percent in 2006, 55 percent in 2007, and 57 percent in 2008. The reasons for increasing the Low- and Moderate-Income Housing Goal are discussed in Section a, above. While the GSEs have lagged the primary market in funding low- and moderate-income loans, they appear to have ample room to improve their performance in that market. The GSEs' mortgage purchases between 1999 and 2002 accounted for 49 percent of the total (single-family and multifamily) conforming mortgage market, but they accounted for only 42 percent of the low- and moderate-income market. A wide variety of quantitative and qualitative indicators demonstrate that the GSEs' have the expertise, resources and financial strength to improve their low- and moderate-income lending performance and close their gap with the market.

3. Central Cities, Rural Areas, and Other Underserved Areas Goal, § 81.13

This section discusses the Department's consideration of the statutory factors in arriving at the proposed new housing goal level for the Underserved Areas Housing Goal.

The Underserved Areas Housing Goal focuses on areas of the nation currently underserved by the mortgage finance system. The 1995 rule provided that mortgage purchases count toward the Underserved Areas Housing Goal if such purchases finance properties that are located in underserved census tracts. At 24 CFR 81.2 of HUD's current rules, HUD defines ''underserved areas'' for metropolitan areas (in central cities and other underserved areas) as census tracts where either: (1) the tract median income is at or below 90 percent of the area median income (AMI); or (2) the minority population is at least 30 percent and the tract median income is at or below 120 percent of AMI. The AMI ratio is calculated by dividing the tract median income by the MSA median income. The minority percent of a tract's population is calculated by dividing the tract's minority population by its total population.

For properties in non-metropolitan (rural) areas, mortgage purchases count toward the Underserved Areas Housing Goal where such purchases finance properties that are located in underserved counties. These are defined as counties where either: (1) the median income in the county does not exceed 95 percent of the greater of the median incomes for the non-metropolitan portions of the state or of the nation as a whole; or (2) minorities comprise at least 30 percent of the residents and the median income in the county does not exceed 120 percent of the greater of the median incomes for the non-metropolitan portions of the state or of the nation as a whole.

This proposed rule bases its proposed level for the Underserved Areas Housing Goal on 2000 Census data on area median incomes and minority percentages for census tracts, counties, MSAs, and the non-metropolitan portions of states and of the entire nation. HUD's analysis, which is sketched below and described in greater detail in Appendix B, has revealed that the effect of using 2000 Census data rather than 1990 data to determine whether areas are underserved increase the percentages of the GSEs' mortgage purchases in underserved areas by an estimated average of 5 percentage points for Fannie Mae and 4 percentage points for Freddie Mac, based on the geographic locations of the GSEs' mortgage purchases in 1999 through 2002. This change reflects geographical shifts in population concentrations by income and minority status from 1990 to 2000. It is for this reason that HUD's proposed level of the Underserved Areas Housing Goal is greater than the existing level by several percentage points more than the increase in the other two Goals.

After analyzing the statutory factors, this proposed rule would: (a) Establish a Goal of 38 percent for the percentage of the total number of dwelling units financed by each GSE's mortgage purchases for properties located in underserved areas for 2005, 39 percent for 2006 and 2007, and 40 percent for 2008; (b) establish census tracts as the spatial basis for establishing whether properties in non-metropolitan (rural) areas count toward the Underserved Areas Housing Goal, in place of counties as in the definition stated above, for the reasons described below; and (c) also establish a Subgoal of 33 percent of the total number of dwelling units financed by each GSE's purchases of home purchase mortgages in metropolitan areas for properties located in underserved areas of metropolitan areas for 2005, rising to 34 percent for 2006, and 35 percent for 2007 and 2008;

A short discussion of the statutory factors reviewed in establishing the Goal follows. Additional information analyzing each of the statutory factors is provided in Appendix B, ''Departmental Considerations to Establish the Central Cities, Rural Areas, and Other Underserved Areas Goal,'' and Appendix D, ''Estimating the Size of the Conventional Conforming Market for Each Housing Goal.''

a. Market Estimate for the Underserved Areas Housing Goal

The Department estimates that dwelling units in underserved areas will account for 35–40 percent of total units financed in the overall conventional conforming mortgage market during the period 2005 through 2008. HUD has developed this range, rather than a specific point estimate, to accommodate the projected effects of different economic and affordability conditions that can reasonably be anticipated. HUD estimates that the underserved areas market averaged 39 percent between 1999 and 2002.

b. Past Performance of the GSEs under the Underserved Areas Housing Goal

As discussed above, a number of changes in goal-counting procedures were adopted as part of HUD's Housing Goals 2000 final rule. Thus it is necessary to provide information using several different measures in order to track changes in the GSEs' performance on the Underserved Areas Housing Goal over the 1996–2002 period. These are shown in Table 4. The same changes in counting rules described for the Low- and Moderate-Income Housing Goal are applicable to the Underserved Areas Housing Goal.

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Table 4

GSE Performance on the Underserved Areas Housing Goal, 1996-2002, and Proposed Goals for 2005-08

	1996	1997	1998	1999	2000	2001*	2002*	2005-08 Proposed Goals 2005	2006	2007	2008
Goal Levels: Actual	21%	24%	24%	24%	24%	31%	31%				
Proposed								**38%**	**39%**	**39%**	**40%**
Fannie Mae Goal Performance											
Official	28.1%	28.8%	27.0%	26.8%	31.0%	32.6%	32.8%				
2001-03 Baseline**	28.2%	28.9%	27.1%	26.8%	31.0%	30.4%	30.2%				
With 2005 Assumptions (Counties)***				32.5%	38.2%	36.4%	35.7%				
With 2005 Assumptions (Tracts)***				**31.6%**	**37.5%**	**35.7%**	**35.0%**				
Freddie Mac Goal Performance											
Official	25.0%	26.3%	26.1%	27.5%	29.2%	31.7%	31.9%				
2001-03 Baseline**	25.0%	26.3%	26.1%	27.6%	29.2%	28.2%	28.4%				
With 2005 Assumptions (Counties)***				32.4%	34.8%	33.3%	33.5%				
With 2005 Assumptions (Tracts)***				**31.6%**	**34.1%**	**32.5%**	**32.8%**				

* Goal level and official performance in 2001-03 are not directly comparable with goal level and performance in 1996-2000, because the goal performance counting rules for 2001-03 differ from those that were in effect for 1996-2000, as discussed in the text. Goal performance is based on official HUD results.

** "2001-03 Baseline" represents performance under current scoring rules (which exclude bonus points and Freddie Mac temporary adjustment factor), with 1990 census data used to determine underserved areas; census tract boundaries as of the 1990 census; and metropolitan area boundaries prior to their re-specification by the Office of Management and Budget in June, 2003.

*** "2005 Assumptions (Counties)" represents performance under current scoring rules (which are proposed to continue for 2005-2008); 2000 census data used to determine underserved areas; census tract boundaries as of the 2000 census; and the Office of Management and Budget's specification of metropolitan area boundaries as of June, 2003. "2005 Assumptions (Tracts)" incorporates the effects of the Departments's proposal to begin using tracts rather than counties to define non-metropolitan underserved areas in 2005.

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Based on the counting rules in effect at that time, as shown under ''official performance'' for 1996–2000 in Table 4, Underserved Areas Housing Goal performance for Fannie Mae generally fluctuated in the range between 27 and 29 percent over the 1996–99 period, before rising to a peak of 31.0 percent in 2000. Freddie Mac's performance started at a lower level, but then increased in several steps, from 25–26 percent in 1996–98 to 27.5 percent in 1999, and a record level of 29.2 percent in 2000. Freddie Mac's performance in 1999 was the only year prior to 2001 in which it exceeded Fannie Mae's performance on this Goal.

Based on current counting rules, including the bonus points and the TAF, as shown under ''official performance'' for 2001 in Table 4, Underserved Areas Housing Goal performance in 2001 was 32.6 percent for Fannie Mae and 31.7 percent for Freddie Mac. Underserved Areas Housing Goal performance in 2002 was 32.8 percent for Fannie Mae and 31.9 percent for Freddie Mac.

Immediately beneath the official Underserved Areas Housing Goal performance percentages in Table 4 are figures showing the GSEs' purchase percentages under this Goal on a consistent basis for the entire 1996–2002 period. The assumptions used were the scoring rules established in HUD's Housing Goals 2000 Final Rule, except that bonus points and the Freddie Mac Temporary Adjustment Factor (which terminated at the end of 2003) are not applied. These figures are termed the ''2001–03 baseline'' assumptions. For 1996–2000 these figures differ from the official performance figures because they incorporate the revised counting procedures, which were not reflected in the official performance figures at that time. For 2001 and 2002 both sets of figures incorporate the revised counting procedures, but the baseline does not incorporate the bonus points and Freddie Mac Temporary Adjustment Factor.

In terms of the 2001–2003 baseline measure, both Fannie Mae and Freddie Mac's Underserved Areas Housing Goal performance reached its maximum in 2000 (Fannie Mae at 31.0 percent and Freddie Mac at 29.2 percent) before declining somewhat in 2001 and 2002. Both GSEs' baseline performance in 2001 and 2002 exceeded the level attained in 1999.

Overall, both GSEs' official performance exceeded their Underserved Areas Housing Goal by significant margins in 1996–99, and by wide margins in 2000. New, higher Goals were established for 2001–03, and despite somewhat lower performance than the level attained in 2000 (largely due to the 2001–02 refinance wave), both GSEs' performance exceeded the new Goal levels in 2001 and 2002.

Appendix B includes a comprehensive analysis of the GSEs' performance in funding mortgages for single-family-owner properties in underserved areas. (The data reported there are based on 2000 Census geography, which produces underserved area figures slightly over five percentage points higher than 1990-based geography.) Between 1999 and 2002, 28.3 percent of Freddie Mac's purchases and 29.5 percent of Fannie Mae's purchases financed properties in underserved neighborhoods, compared with 31.5 percent home purchase loans originated in the conventional conforming market (excluding B&C loans). Thus, Freddie Mac performed at 90 percent of the market level, while Fannie Mae performed at 94 percent of the market level—both results similar to those reported in Appendix B for underserved areas based on 1990 Census geography. The 2000-based results also show that Fannie Mae has improved its performance and matched the primary market in funding underserved areas during 2002. The share of Fannie Mae's purchases going to underserved areas increased from 25.7 in 1999 to 32.3 percent in 2002, which placed it at the market level of 32.3 percent. However, the 2000-based results show that, like Freddie Mac, Fannie Mae's longer-term performance (since 1996) as well as its recent average performance (1999 to 2001) has consistently been below market levels. But, it is encouraging that Fannie Mae significantly improved its performance relative to the market during the first two years of HUD's higher Housing Goal levels.

In evaluating the GSEs' past performance, it should be noted that while borrowers in underserved metropolitan areas tend to have much lower incomes than borrowers in other areas, this does not mean that GSE mortgage purchases in underserved areas must necessarily be mortgages on housing for lower income families. Between 1999 and 2001, housing for above median-income households accounted for nearly 60 percent of the single-family owner-occupied mortgages the GSEs purchased in underserved areas.

Beneath the 2001–03 baseline figures in Table 4 are two additional rows of figures designated ''2005 Assumptions.'' These figures show the effects of applying 2000 Census data and the new specification of Metropolitan Statistical Areas released by the Office of Management and Budget in 2003 to the identification of underserved areas for purposes of measuring historical GSE goal performance. The second of the two lines also incorporates the effects of the Department's proposed change from counties to census tracts as the basis for identifying underserved areas outside of metropolitan areas beginning in 2005.

HUD's determination of underserved areas for purposes of computing the GSEs' performance on the Underserved Areas Housing Goal has through 2002 been based on area median incomes and area minority percentages from the 1990 Census. HUD applied the existing numerical thresholds for minority percentages and median incomes to 2000 Census data and ascertained that the proportion of underserved census tracts and the proportion of housing units in underserved census tracts in metropolitan areas increases significantly from 1990 levels: from 47.5 percent to 54.9 percent of census tracts underserved and from 44.3 percent to 52.5 percent of population in underserved census tracts (including the effects of the 2003 re-specification of Metropolitan Statistical Areas). Comparable shifts at the county level in non-metropolitan areas were found to be of much smaller magnitude. Further, HUD estimated the spatial distribution of GSE mortgage purchases across metropolitan census tracts and non-metropolitan counties for recent years. The findings were that for 2000, 2001, and 2002, Fannie Mae's performance figures are an estimated 7.2 percent, 6.0 percent, and 5.5 percent higher in terms of 2000 Census geography than with 1990 Census geography. The corresponding figures for Freddie Mac are 5.6 percent, 5.1 percent, and 5.1 percent larger, respectively. With a further shift to tract-based definitions the figures for Fannie Mae are reduced by 0.7 percentage points in each of the three years, and for Freddie Mac 0.7, 0.8, and 0.7 percentage points, respectively. HUD has taken account of these shifts in establishing the level of the Underserved Areas Housing Goal for 2005 and beyond.

HUD originally adopted its current county-based definition for targeting GSE purchases to underserved non-metropolitan areas primarily based on information that rural lenders did not perceive their market areas in terms of census tracts, but rather, in terms of counties. A further concern was an apparent lack of reliability of geocoding software applied to non-metropolitan areas. Recent research summarized in Appendix B indicates that a tract-based system would improve the extent to which the underserved area definition distinguishes areas by key socioeconomic and demographic characteristics such as median family income, poverty, unemployment, school dropout rates, and minority populations. Under a tract-based definition underserved areas stand out more as areas of lower income and low economic activity and as having somewhat larger minority population proportions. A tract-based definition would also improve the targeting of the goal to areas with relatively greater housing needs. Based on these findings, which are detailed in Appendix B, HUD is proposing to re-specify the definition of underserved areas within non-metropolitan (rural) areas to be based on census tracts rather than counties.

c. Proposed Underserved Areas Home Purchase Subgoal for 2005–2008

The Department believes the GSEs can play a leadership role in underserved markets. To facilitate this leadership, the Department is proposing a Subgoal of 33 percent for each GSE's acquisitions of home purchase mortgages on properties located in the underserved census tracts of metropolitan areas for 2005, rising to 34 percent in 2006 and 35 percent in 2007 and 2008. The purpose of this Subgoal is to encourage the GSEs to improve their purchases of mortgages for homeownership in underserved areas, thus providing additional credit and capital for neighborhoods that historically have not been adequately served by the mortgage industry. If the GSEs meet this Subgoal, they will be leading the primary market, based on the census tract characteristics of home purchase loans reported in HMDA. Between 1999 and 2002, HMDA data show that underserved areas accounted for 32.3 percent of single-family-owner loans originated in the conventional conforming market of metropolitan areas. To reach the 33 percent Subgoal for 2005, both GSEs would have to improve their performance, as shown in Table 2—Fannie Mae by 1.9 percentage points over its average performance of 31.1 percent, and Freddie Mac by 3.5 percentage points over its average performance of 29.5 percent during 2001 and 2002. These required improvements would increase further by one percentage point in 2006 and by an additional one percentage point in 2007–08 under HUD's proposal. The Subgoal applies only to the GSEs' purchases in metropolitan areas because the HMDA-based market benchmark is only available for metropolitan areas.

Section II.B.2 of this preamble and Section I of Appendix B discuss the reasons why the Department is establishing a Subgoal for home purchase mortgages in underserved areas namely: (1) The GSEs' have the resources and the ability to lead the market in providing funding in underserved neighborhoods; (2) the GSEs have not led the market, even though they have the ability to do so; (3) troublesome disparities in our housing and mortgage markets indicate a continuing need for increased GSE activity; and (4) there are ample opportunities for the GSEs to improve their underserved area performance in the home purchase market. Although single-family-owner mortgages comprise the ''bread and butter'' of the GSEs' business, the GSEs have lagged behind the primary market in financing properties in underserved areas. For the foregoing reasons, the Secretary believes that the GSEs can do more to raise the share of their home loan purchases in underserved areas. This can be accomplished by building on efforts that the enterprises have already started, including their new affordable lending products, their many partnership efforts, their outreach to inner city neighborhoods, their incorporation of greater flexibility into their underwriting guidelines, and their purchases of seasoned CRA loans. A wide variety of quantitative and qualitative indicators demonstrate that the GSEs have the resources and financial strength to improve their affordable lending performance enough to lead the market in underserved areas.

d. Proposed Goal Levels for 2005–2008

The Department is proposing to increase the Underserved Areas Housing Goal to 38 percent for 2005, 39 percent for 2006 and 2007, and 40 percent for 2008. The reasons for increasing the Underserved Areas Housing Goal are discussed in Sections I.C and II.A of this preamble. While the GSEs have lagged the primary market in funding loans in underserved areas, they appear to have ample room to improve their performance in that market. The GSEs' mortgage purchases between 1999 and 2002 accounted for 49 percent of the total (single-family and multifamily) conforming mortgage market, but they accounted for only 41 percent of the underserved areas market. A wide variety of quantitative and qualitative indicators demonstrate that the GSEs have the expertise, resources and financial strength to improve their performance in underserved areas and to close their gap with the market.

4. Special Affordable Housing Goal, § 81.14

This section discusses the Department's consideration of the statutory factors in arriving at the proposed Housing Goal level for the Special Affordable Housing Goal, which counts mortgages on housing for very low-income families and low-income families living in low-income areas.

After analyzing the statutory factors, this proposed rule would establish: (a) A Goal of 22 percent for the percentage of the total number of dwelling units financed by each GSE's mortgage purchases that are for special affordable housing, affordable to very low-income families and families living in low-income areas for 2005, rising to 24 percent in 2006, 26 percent in 2007, and 28 percent in 2008; (b) a Subgoal of 1 percent of each GSE's combined annual average mortgage purchases in 2000, 2001, and 2002, for each GSE's special affordable mortgage purchases that are for multifamily housing in 2005–2008; and (c) a Subgoal of 17 percent of the total number of each GSE's purchases of home purchase mortgages in metropolitan areas that are for housing affordable to very low income families and low-income families in low-income areas for 2005, rising to 18 percent in 2006, 19 percent in 2007, and 19 percent in 2008.

A short discussion of the statutory factors for establishing the Goal follows. Additional information analyzing each of the statutory factors is provided in Appendix C, ''Departmental Considerations to Establish the Special Affordable Housing Goal,'' and Appendix D, ''Estimating the Size of the Conventional Conforming Market for Each Housing Goal.''

a. Market Estimate for the Special Affordable Housing Goal

The Department estimates that dwelling units serving very low-income families and low-income families living in low-income areas will account for 24–28 percent of total units financed in the overall conventional conforming mortgage market during the period 2005 through 2008. HUD has developed this range, rather than a point estimate, to account for the projected effects of different economic conditions that can reasonably be anticipated. HUD also estimates that the special affordable market averaged 28 percent between 1999 and 2002.

b. Past Performance of the GSEs Under the Special Affordable Housing Goal

As discussed above, a number of changes in Goal-counting procedures were adopted as part of HUD's Housing Goals 2000 final rule. Thus, it is necessary to provide information using several different measures in order to track changes in performance on the Special Affordable Housing Goal over the 1996–2002 period. These are shown in Table 5.

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Table 5

GSE Performance on the Special Affordable Housing Goal and Multifamily Subgoals, 1996-2002, and Proposed Goals for 2005-08

								2005-08 Proposed Goals			
	1996	1997	1998	1999	2000	2001*	2002*	2005	2006	2007	2008
Goal Levels: Actual	12%	14%	14%	14%	14%	20%	20%				
Proposed								**22%**	**24%**	**26%**	**28%**
Fannie Mae Goal Performance											
Official	15.4%	17.0%	14.3%	17.6%	19.2%	21.6%	21.4%				
2001-03 Baseline**	16.7%	19.3%	16.3%	18.5%	21.4%	20.2%	19.9%				
With 2005 Assumptions***				**18.6%**	**21.7%**	**20.1%**	**19.4%**				
Freddie Mac Goal Performance											
Official	14.0%	15.2%	15.9%	17.2%	20.7%	22.6%	21.4%				
2001-03 Baseline**	14.0%	15.2%	16.0%	17.4%	21.0%	19.3%	18.6%				
With 2005 Assumptions***				**17.4%**	**20.8%**	**19.1%**	**17.8%**				
Multifamily Subgoals ($ billions):											
Fannie Mae Subgoal	$1.29	$1.29	$1.29	$1.29	$1.29	$2.85	$2.85	**$5.49**	**$5.49**	**$5.49**	**$5.49**
Fannie Mae Performance	**$2.37**	**$3.19**	**$3.53**	**$4.04**	**$3.79**	**$7.36**	**$7.57**				
Ratio, Performance/Subgoal	1.84	2.47	2.74	3.13	2.94	2.58	2.66				
Freddie Mac Subgoal	$0.99	$0.99	$0.99	$0.99	$0.99	$2.11	$2.11	**$3.92**	**$3.92**	**$3.92**	**$3.92**
Freddie Mac Performance	**$1.06**	**$1.21**	**$2.69**	**$2.26**	**$2.40**	**$4.65**	**$5.22**				
Ratio, Performance/Subgoal	1.07	1.22	2.72	2.28	2.42	2.20	2.47				

* Goal level and official performance in 2001-03 are not directly comparable with goal level and performance in 1996-2000, because the goal performance counting rules for 2001-03 differ from those that were in effect for 1996-2000, as discussed in the text. Goal performance is based on official HUD results. Multifamily subgoal figures for 2001-03 are comparable with figures for 1996-2000.

** "2001-03 Baseline" represents performance under current scoring rules (which exclude bonus points and Freddie Mac temporary adjustment factor), with 1990 census data used to determine low-income areas; no use of 2000 census data in estimating area median incomes; census tract boundaries as of the 1990 census and metropolitan area boundaries prior to their re-specification by the Office of Management and Budget in June, 2003.

*** "2005 Assumptions" represents performance under current scoring rules (which are proposed to continue for 2005-2008) with 2000 census data used to determine low-income areas and in estimating area median incomes; census tract boundaries as of the 2000 census; and the Office of Management and Budget's specification of metropolitan area boundaries as of June, 2003.

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Based on the counting rules in effect at that time, as shown under ''official performance'' for 1996–2000 in Table 5, Special Affordable Housing Goal performance for Fannie Mae generally fluctuated in the range between 14 and 17 percent over the 1996–99 period, before rising to a peak of 19.2 percent in 2000. Freddie Mac's performance started at a lower level, but then increased in several steps, from 14–16 percent in 1996–98 to 17.2 percent in 1999, and to a record level of 20.7 percent in 2000. That was the only year prior to 2001 in which Freddie Mac's performance exceeded Fannie Mae's performance on this Goal.

Based on current counting rules, as shown under ''official performance'' for 2001 in Table 5, Special Affordable Housing Goal performance in 2001 was 21.6 percent for Fannie Mae and 22.6 percent for Freddie Mac. Special Affordable Housing Goal performance in 2002 was 21.4 percent for Fannie Mae and 21.4 percent for Freddie Mac.

Immediately beneath the official Special Affordable Housing Goal performance percentages in Table 5 are figures showing the GSEs' special affordable purchase percentages on a consistent basis for the entire 1996–2002 period. The assumptions used were the scoring rules established in HUD's Housing Goals 2000 Final Rule except that bonus points and the Freddie Mac Temporary Adjustment Factor (which were terminated at the end of 2003) are not applied. These are termed the ''2001–03 baseline'' assumptions. In terms of this measure, both Fannie Mae and Freddie Mac's special affordable performance reached its maximum in 2000 (Fannie Mae at 21.4 percent and Freddie Mac at 21.0 percent) before declining somewhat in 2001 and then declining further in 2002. Both GSEs' baseline performance in 2002 exceeded the level attained in 1999.

Overall, both GSEs' performance exceeded HUD's Special Affordable Housing Goals by significant margins in 1996–99, and by wide margins in 2000. New, higher Goals were established for 2001–03, and despite somewhat lower performance than the level attained in 2000 (largely due to the 2001–02 refinance wave, as discussed under the Low- and Moderate-Income Housing Goal), both GSEs' performance exceeded the new Goal levels in 2001–02.

The Special Affordable Housing Goal is designed, in part, to ensure that the GSEs maintain a consistent focus on serving the low- and very low-income portion of the housing market where housing needs are greatest. Appendices A and B use HMDA data and GSE loan-level data for home purchase mortgages on single-family owner-occupied properties in metropolitan areas to compare the GSEs' performance in special affordable lending to the performance of depositories and other lenders in the conventional conforming market. There are two main findings with respect to the special affordable category. First, Fannie Mae and Freddie Mac have historically lagged depositories and the overall market in providing mortgage funds for special affordable housing. Between 1993 and 2002, 11.8 percent of Freddie Mac's mortgage purchases, 12.7 percent of Fannie Mae's purchases, 15.4 percent of loans originated by depositories, and 15.4 percent of loans originated in the conventional conforming market (without estimated B&C loans) were for special affordable housing.

Second, while both GSEs have improved their performance over the past few years, Fannie Mae has made more progress than Freddie Mac in closing its gap with the market. The share of Fannie Mae's purchases going to special affordable loans increased from 12.5 percent in 1999 to 16.3 percent in 2002, the latter figure being at the 2002 market level of 16.3 percent. The share of Freddie Mac's purchases going to special affordable loans increased from 12.8 percent in 1999 to 15.8 percent in 2002, the latter figure being below the 2002 market level of 16.3 percent.

Section G in Appendix A discusses the role of the GSEs both in the overall special affordable market and in the different segments (single-family owner, single-family rental, and multifamily rental) of the special affordable market. The GSEs' special affordable purchases accounted for 35 percent of all special affordable owner and rental units that were financed in the conventional conforming market between 1999 and 2002. The GSEs' 35-percent share of the special affordable market was below their 49-percent share of the overall market. Even in the owner market, where the GSEs account for 57 percent of the market, their share of the special affordable market was only 49 percent. While the GSEs improved their market shares during 2002, the analysis suggests that the GSEs are not leading the single-family market in purchasing loans that qualify for the Special Affordable Housing Goal. There is room and ample opportunity for the GSEs to improve their performance in purchasing affordable loans at the lower-income end of the market.

The multifamily market is especially important in the establishment of the Special Affordable Housing Goal for Fannie Mae and Freddie Mac because of the relatively high percentage of multifamily units meeting the Special Affordable Housing Goal. For example, between 1999 and 2002, 53 percent of units financed by Fannie Mae's multifamily mortgage purchases met the Special Affordable Housing Goal, representing 27 percent of units counted toward the Special Affordable Housing Goal, during a period when multifamily units represented only 10 percent of its total purchase volume. For Freddie Mac, 49 percent of units financed by multifamily mortgage purchases met the Special Affordable Housing Goal, representing 23 percent of units counted toward the Special Affordable Housing Goal, during a period when multifamily units represented only 9 percent of its total purchase volume.

c. Proposed Special Affordable Home Purchase Subgoal for 2005–2008

The Secretary believes the GSEs can play a leadership role in the special affordable market generally and the home purchase special affordable market in particular. Thus, the Department is proposing a Subgoal of 17 percent for each GSE's purchases of home purchase mortgages for special affordable housing located in metropolitan areas for 2005, rising to 18 percent in 2006, and 19 percent in 2007 and 2008. The purpose of this Subgoal is to encourage the GSEs to improve their purchases of home purchase mortgages on special affordable housing, thus expanding homeownership opportunities for very-low-income borrowers and low-income borrowers in low-income areas, including minority first-time homebuyers who are expected to enter the housing market over the next few years. If the GSEs meet this Subgoal, they will be leading the primary market, based on the income characteristics of home purchase loans reported in HMDA. Between 1999 and 2002, HMDA data show that special affordable housing accounted for an average of 16.4 percent of single-family-owner home purchase loans originated in the conventional conforming market in metropolitan areas. Loans in the B&C portion of the subprime market are not included in these averages. To reach the 17 percent Subgoal, both GSEs would have to improve their performance in 2005, as shown in Table 2—Fannie Mae by 1.4 percentage points over its average performance of 15.6 percent during 2001 and 2002, and Freddie Mac by 1.9 percentage points over its performance of 15.1 percent during the same period. These required improvements would increase further by one percentage point in 2006 and by an additional one percentage point in 2007–08 under HUD's proposal. As discussed previously, the Subgoal applies only to the GSEs' purchases in metropolitan areas because the HMDA-based market benchmark is only available for metropolitan areas.

Section II.B.2 of this preamble and Section D of Appendix C discuss reasons why the Department set the Subgoal for special affordable loans.

d. Special Affordable Housing Goal: Multifamily Subgoals

Based on the GSEs' past performance on the Special Affordable Multifamily Subgoals, and on the outlook for the multifamily mortgage market, HUD is proposing that these Subgoals be retained for the 2005–2008 period. Unlike the overall Goals, which are expressed in terms of minimum Goal-qualifying percentages of total units financed, these Subgoals for 2001–03 and in prior years have been expressed in terms of minimum dollar volumes of Goal-qualifying multifamily mortgage purchases. Specifically, each GSE's special affordable multifamily Subgoal is currently equal to 1.0 percent of its average total (single-family plus multifamily) mortgage volume over the 1997–99 period. Under this formulation, in October 2000 the Subgoals were set at $2.85 billion per year for Fannie Mae and $2.11 billion per year for Freddie Mac, in each of calendar years 2001 through 2003. These Subgoals are also in effect for 2004. These represented increases from the Goals for 1996–2000, which were $1.29 billion annually for Fannie Mae and $0.99 billion annually for Freddie Mac.

HUD's Determination. The multifamily mortgage market and both GSEs' multifamily transactions volume grew significantly over the 1993–2002 period, indicating that both enterprises have provided increasing support for the multifamily market, and that they have the ability to continue to provide further support for the market.

Specifically, Fannie Mae's total eligible multifamily mortgage purchase volume increased from $4.6 billion in 1993 to $12.5 billion in 1998, and then jumped sharply to $18.7 billion in 2001 and $18.3 billion in 2002. Its special affordable multifamily mortgage purchases followed a similar path, rising from $1.7 billion in 1993 to $3.5 billion in 1998 and $4.0 billion in 1999, and also jumping sharply to $7.4 billion in 2001 and $7.6 billion in 2002. As a result of its strong performance, Fannie Mae's purchases have been at least twice its minimum subgoal in every year since 1997—247 percent of the Subgoal in that year, 274 percent in 1998, 313 percent in 1999, 294 percent in 2000, and, under the new Subgoal level, 258 percent in 2001, and 266 percent in 2002.

Freddie Mac's total eligible multifamily mortgage purchase volume increased even more sharply, from $0.2 billion in 1993 to $6.6 billion in 1998, and then jumped further in 2001 to $11.8 billion and $18.3 billion in 2002. Its special affordable multifamily mortgage purchases followed a similar path, rising from $0.1 billion in 1993 to $2.7 billion in 1998, and also jumping sharply to $4.6 billion in 2001 and $5.2 billion in 2002. As a result of its strong performance, Freddie Mac's purchases have also been at least twice its minimum Subgoal in every year since 1998—272 percent of the Subgoal in that year, 229 percent in 1999, 243 percent in 2000, and, under the new Subgoal level, 220 percent in 2001, and 247 percent in 2002.

The Special Affordable Multifamily Subgoals set forth in this proposed rule are reasonable and appropriate based on the Department's analysis of this market. The Department's decision to retain these Subgoals is based on HUD's analysis which indicates that multifamily housing still serves the housing needs of lower-income families and families in low-income areas to a greater extent than single-family housing. By retaining the Special Affordable Multifamily Subgoal, the Department ensures that the GSEs continue their activity in this market, and that they achieve at least a minimum level of special affordable multifamily mortgage purchases that are affordable to lower-income families. The Department proposes to retain each GSE's Special Affordable Multifamily Subgoal at 1.0 percent of its average annual dollar volume of total (single-family and multifamily) mortgage purchases over the 2000–2002 period. In dollar terms, the Department's proposal is $5.49 billion per year in special affordable multifamily mortgage purchases for Fannie Mae, and $3.92 billion per year in special affordable multifamily mortgage purchases for Freddie Mac. These Subgoals would be less than actual special affordable multifamily mortgage purchase volume in 2001 and 2002 for both GSEs. Thus, the Department believes that they would be feasible for the 2005–2008 period.

e. Proposed Special Affordable Housing Goal Levels for 2005–2008

The Department is proposing to increase the Special Affordable Housing Goal to 22 percent for 2005, 24 percent for 2006, 26 percent for 2007, and 28 percent for 2008. The reasons for increasing the Special Affordable Housing Goal are discussed above in this preamble. Since the GSEs have historically lagged the primary market in funding special affordable loans, they have ample room to improve their performance in that market. The GSEs' mortgage purchases between 1999 and 2002 accounted for 49 percent of the total (single-family and multifamily) conforming mortgage market, but they accounted for only 35 percent of the special affordable market. A wide variety of quantitative and qualitative indicators demonstrate that the GSEs have the expertise, resources and financial strength to improve their special affordable lending performance and close their gap with the market.

C. Subpart I—Other Provisions

Section 81.102—Independent verification authority.

See Section II of this preamble for a complete discussion of the Department's proposal to amend § 81.102 to provide additional means of verifying and enforcing GSE data submissions.

IV. Findings and Certifications

Executive Order 12866

The Office of Management and Budget (OMB) reviewed this proposed rule under Executive Order 12866, *Regulatory Planning and Review,* which the President issued on September 30, 1993. This rule was determined to be economically significant under E.O. 12866. Any changes made to this proposed rule subsequent to its submission to OMB are identified in the docket file, which is available for public inspection between 8 a.m. and 5 p.m. weekdays in the Office of the Rules Docket Clerk, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC. The Economic Analysis prepared for this rule is also available for public inspection in the Office of the Rules Docket Clerk and on HUD's Web site at *http://www.hud.gov.*

Congressional Review of Major Proposed Rules

This rule is a ''major rule'' as defined in Chapter 8 of 5 U.S.C. At the final rule stage, the rule will be submitted for Congressional review in accordance with this chapter.

Paperwork Reduction Act

HUD's collection of information on the GSEs' activities has been reviewed and authorized by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520), as implemented by OMB in regulations at 5 CFR part 1320. The OMB control number is 2502–0514.

Environmental Impact

This proposed rule would not direct, provide for assistance or loan and mortgage insurance for, or otherwise govern or regulate real property acquisition, disposition, lease, rehabilitation, alteration, demolition, or new construction; nor would it establish, revise, or provide for standards for construction or construction materials, manufactured housing, or occupancy. Accordingly, under 24 CFR 50.19(c)(1) of HUD's regulations, this proposed rule is categorically excluded from environmental review under the National Environmental Policy Act of 1969 (42 U.S.C. 4321).

Regulatory Flexibility Act

The Secretary, in accordance with the Regulatory Flexibility Act (5 U.S.C. 605(b)), has reviewed this rule before publication and by approving it certifies that this rule would not have a significant economic impact on a substantial number of small entities. This rule is applicable only to the GSEs, which are not small entities for purposes of the Regulatory Flexibility Act. Therefore, the rule does not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act.

Executive Order 13132, Federalism

Executive Order 13132 (''Federalism'') prohibits, to the extent practicable and permitted by law, an agency from promulgating a regulation that has federalism implications and either imposes substantial direct compliance costs on state and local governments and is not required by statute, or preempts state law, unless the relevant requirements of section 6 of the executive order are met. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the executive order.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (12 U.S.C. 1531—1538) (UMRA) establishes requirements for federal agencies to assess the effects of their regulatory actions on state, local, and tribal governments, and the private sector. This proposed rule would not impose any federal mandates on any state, local, or tribal government, or on the private sector, within the meaning of UMRA.

List of Subjects in 24 CFR Part 81

Accounting, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Securities.

For the reasons discussed in the preamble, HUD proposes to amend 24 CFR part 81 as follows:

PART 81—THE SECRETARY OF HUD'S REGULATION OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION (FANNIE MAE) AND THE FEDERAL HOME LOAN MORTGAGE CORPORATION (FREDDIE MAC)

1. The authority citation for 24 CFR part 81 continues to read as follows:

Authority: 12 U.S.C. 1451 *et seq.*, 1716–1723h, and 4501–4641; 42 U.S.C. 3535(d) and 3601–3619.

2. In § 81.2, revise the definitions of ''Metropolitan area,'' ''Minority,'' and paragraph (2) of the definition of ''Underserved area,'' and add a new definition of the term ''Home Purchase Mortgage,'' in alphabetical order, to read as follows:

§ 81.2 Definitions.

* * * * *

Home Purchase Mortgage means a residential mortgage for the purchase of an owner-occupied single-family property.

* * * * *

Metropolitan area means a metropolitan statistical area (''MSA''), or a portion of such an area for which median family income estimates are published annually by HUD.

Minority means any individual who is included within any one or more of the following racial and ethnic categories:

(1) American Indian or Alaskan Native—a person having origins in any of the original peoples of North and South America (including Central America), and who maintains tribal affiliation or community attachment;

(2) Asian—a person having origins in any of the original peoples of the Far East, Southeast Asia, or the Indian subcontinent, including, for example, Cambodia, China, India, Japan, Korea, Malaysia, Pakistan, the Philippine Islands, Thailand, and Vietnam;

(3) Black or African American—a person having origins in any of the black racial groups of Africa;

(4) Hispanic or Latino—a person of Cuban, Mexican, Puerto Rican, South or Central American, or other Spanish culture or origin, regardless of race; and

(5) Native Hawaiian or Other Pacific Islander—a person having origins in any of the original peoples of Hawaii, Guam, Samoa, or other Pacific Islands.

* * * * *

Underserved area means * * *

(2) For purposes of the definition of ''Rural area,'' a whole census tract, a Federal or State American Indian reservation or tribal or individual trust land, or the balance of a census tract excluding the area within any Federal or State American Indian reservation or tribal or individual trust land, having:

(i) A median income at or below 120 percent of the greater of the State non-metropolitan median income or the nationwide non-metropolitan median income and a minority population of 30 percent or greater; or

(ii) A median income at or below 95 percent of the greater of the State non-metropolitan median income or nationwide non-metropolitan median income.

* * * * *

3. In § 81.12, revise the last sentence of paragraph (b) and revise paragraph (c), to read as follows:

§ 81.12 Low- and Moderate-Income Housing Goal.

* * * * *

(b) Factors. * * * A statement documenting HUD's considerations and findings with respect to these factors, entitled ''Departmental Considerations to Establish the Low- and Moderate-Income Housing Goal,'' was published in the **Federal Register** on date of publication of final rule in the **Federal Register**].

(c) *Goals.* The annual goals for each GSE's purchases of mortgages on housing for low- and moderate-income families are:

(1) For the year 2005, 52 percent of the total number of dwelling units financed by that GSE's mortgage purchases unless otherwise adjusted by HUD in accordance with FHEFSSA. In addition, as a Low- and Moderate-Income Housing Home Purchase Subgoal, 45 percent of the total number of home purchase mortgages in metropolitan areas financed by that GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Low- and Moderate-Income Housing Goal in the year 2005 unless otherwise adjusted by HUD in accordance with FHEFSSA;

(2) For the year 2006, 53 percent of the total number of dwelling units financed by that GSE's mortgage purchases unless otherwise adjusted by HUD in accordance with FHEFSSA. In addition, as a Low- and Moderate-Income Housing Home Purchase Subgoal, 46 percent of the total number of home purchase mortgages in

metropolitan areas financed by that GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Low- and Moderate-Income Housing Goal in the year 2006 unless otherwise adjusted by HUD in accordance with FHEFSSA;

(3) For the year 2007, 55 percent of the total number of dwelling units financed by that GSE's mortgage purchases unless otherwise adjusted by HUD in accordance with FHEFSSA. In addition, as a Low- and Moderate-Income Housing Home Purchase Subgoal, 47 percent of the total number of home purchase mortgages in metropolitan areas financed by that GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Low- and Moderate-Income Housing Goal in the year 2007 unless otherwise adjusted by HUD in accordance with FHEFSSA;

(4) For the year 2008, 57 percent of the total number of dwelling units financed by that GSE's mortgage purchases unless otherwise adjusted by HUD in accordance with FHEFSSA. In addition, as a Low- and Moderate-Income Housing Home Purchase Subgoal, 47 percent of the total number of home purchase mortgages in metropolitan areas financed by that GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Low- and Moderate-Income Housing Goal in the year 2008 unless otherwise adjusted by HUD in accordance with FHEFSSA; and

(5) For the year 2009 and thereafter HUD shall establish annual goals. Pending establishment of goals for the year 2009 and thereafter, the annual goal for each of those years shall be 57 percent of the total number of dwelling units financed by that GSE's mortgage purchases in each of those years. In addition, as a Low and Moderate Income Housing Home Purchase Subgoal, 47 percent of the total number of home purchase mortgages in metropolitan areas financed by that GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Low- and Moderate-Income Housing Goal in each of those years unless otherwise adjusted by HUD in accordance with FHEFSSA.

4. In § 81.13, revise the last sentence of paragraph (b) and revise paragraph (c), to read as follows:

§ 81.13 Central Cities, Rural Areas, and Other Underserved Areas Housing Goal.

* * * * *

(b) *Factors.* * * * A statement documenting HUD's considerations and findings with respect to these factors, entitled ''Departmental Considerations to Establish the Central Cities, Rural Areas, and Other Underserved Areas Housing Goal,'' was published in the **Federal Register** on [date of publication of final rule in the **Federal Register**].

(c) *Goals.* The annual goals for each GSE's purchases of mortgages on housing located in central cities, rural areas, and other underserved areas are:

(1) For the year 2005, 38 percent of the total number of dwelling units financed by that GSE's mortgage purchases unless otherwise adjusted by HUD in accordance with FHEFSSA. In addition, as a Central Cities, Rural Areas, and Other Underserved Areas Home Purchase Subgoal, 33 percent of the total number of home purchase mortgages in metropolitan areas financed by that GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Central Cities, Rural Areas, and Other Underserved Areas Housing Goal in the year 2005 unless otherwise adjusted by HUD in accordance with FHEFSSA;

(2) For the year 2006, 39 percent of the total number of dwelling units financed by that GSE's mortgage purchases unless otherwise adjusted by HUD in accordance with FHEFSSA. In addition, as a Central Cities, Rural Areas, and Other Underserved Areas Home Purchase Subgoal, 34 percent of the total number of home purchase mortgages in metropolitan areas financed by that GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Central Cities, Rural Areas, and Other Underserved Areas Housing Goal in the year 2006 unless otherwise adjusted by HUD in accordance with FHEFSSA;

(3) For the year 2007, 39 percent of the total number of dwelling units financed by that GSE's mortgage purchases unless otherwise adjusted by HUD in accordance with FHEFSSA. In addition, as a Central Cities, Rural Areas, and Other Underserved Areas Home Purchase Subgoal, 35 percent of the total number of home purchase mortgages in metropolitan areas financed by that GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Central Cities, Rural Areas, and Other Underserved Areas Housing Goal in the year 2007 unless otherwise adjusted by HUD in accordance with FHEFSSA;

(4) For the year 2008, 40 percent of the total number of dwelling units financed by that GSE's mortgage purchases unless otherwise adjusted by HUD in accordance with FHEFSSA. In addition, as a Central Cities, Rural Areas, and Other Underserved Areas Home Purchase Subgoal, 35 percent of the total number of home purchase mortgages in metropolitan areas financed by that GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Central Cities, Rural Areas, and Other Underserved Areas Housing Goal in the year 2008 unless otherwise adjusted by HUD in accordance with FHEFSSA; and

(5) For the year 2009 and thereafter HUD shall establish annual goals. Pending establishment of goals for the year 2009 and thereafter, the annual goal for each of those years shall be 40 percent of the total number of dwelling units financed by that GSE's mortgage purchases in each of those years. In addition, as a Central Cities, Rural Areas, and Other Underserved Areas Home Purchase Subgoal, 35 percent of the total number of home purchase mortgages in metropolitan areas financed by that GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Central Cities, Rural Areas, and Other Underserved Areas Housing Goal in each of those years unless otherwise adjusted by HUD in accordance with FHEFSSA.

* * * * *

5. In § 81.14, revise the last sentence of paragraph (b) and revise paragraph (c), to read as follows:

§ 81.14 Special Affordable Housing Goal.

* * * * *

(b) * * * A statement documenting HUD's considerations and findings with respect to these factors, entitled ''Departmental Considerations to Establish the Special Affordable Housing Goal,'' was published in the **Federal Register** on [date of publication of final rule in the **Federal Register**].

(c) *Goals.* The annual goals for each GSE's purchases of mortgages on rental and owner-occupied housing meeting the then-existing, unaddressed needs of and affordable to low-income families in low-income areas and very low-income families are:

(1) For the year 2005, 22 percent of the total number of dwelling units financed by each GSE's mortgage purchases unless otherwise adjusted by HUD in accordance with FHEFSSA. The goal for the year 2005 shall include mortgage purchases financing dwelling units in multifamily housing totaling not less than 1.0 percent of the average annual dollar volume of combined (single family and multifamily) mortgages purchased by the respective GSE in 2000, 2001, and 2002, unless otherwise adjusted by HUD in

accordance with FHEFSSA. In addition, as a Special Affordable Housing Home Purchase Subgoal, 17 percent of the total number of home purchase mortgages in metropolitan areas financed by each GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Special Affordable Housing Goal in the year 2005 unless otherwise adjusted by HUD in accordance with FHEFSSA;

(2) For the year 2006, 24 percent of the total number of dwelling units financed by each GSE's mortgage purchases unless otherwise adjusted by HUD in accordance with FHEFSSA. The goal for the year 2006 shall include mortgage purchases financing dwelling units in multifamily housing totaling not less than 1.0 percent of the average annual dollar volume of combined (single-family and multifamily) mortgages purchased by the respective GSE in 2000, 2001, and 2002, unless otherwise adjusted by HUD in accordance with FHEFSSA. In addition, as a Special Affordable Housing Home Purchase Subgoal, 18 percent of the total number of home purchase mortgages in metropolitan areas financed by each GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Special Affordable Housing Goal in the year 2006 unless otherwise adjusted by HUD in accordance with FHEFSSA;

(3) For the year 2007, 26 percent of the total number of dwelling units financed by each GSE's mortgage purchases unless otherwise adjusted by HUD in accordance with FHEFSSA. The goal for the year 2007 shall include mortgage purchases financing dwelling units in multifamily housing totaling not less than 1.0 percent of the average annual dollar volume of combined (single-family and multifamily) mortgages purchased by the respective GSE in 2000, 2001, and 2002, unless otherwise adjusted by HUD in accordance with FHEFSSA. In addition, as a Special Affordable Housing Home Purchase Subgoal, 19 percent of the total number of home purchase mortgages in metropolitan areas financed by each GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Special Affordable Housing Goal in the year 2007 unless otherwise adjusted by HUD in accordance with FHEFSSA;

(4) For the year 2008, 28 percent of the total number of dwelling units financed by each GSE's mortgage purchases unless otherwise adjusted by HUD in accordance with FHEFSSA. The goal for the year 2008 shall include mortgage purchases financing dwelling units in multifamily housing totaling not less than 1.0 percent of the average annual dollar volume of combined (single-family and multifamily) mortgages purchased by the respective GSE in 2000, 2001, and 2002, unless otherwise adjusted by HUD in accordance with FHEFSSA. In addition, as a Special Affordable Housing Home Purchase Subgoal, 19 percent of the total number of home purchase mortgages in metropolitan areas financed by each GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Special Affordable Housing Goal in the year 2008 unless otherwise adjusted by HUD in accordance with FHEFSSA; and

(5) For the year 2009 and thereafter HUD shall establish annual goals. Pending establishment of goals for the year 2009 and thereafter, the annual goal for each of those years shall be 28 percent of the total number of dwelling units financed by each GSE's mortgage purchases in each of those years. The goal for each such year shall include mortgage purchases financing dwelling units in multifamily housing totaling not less than 1.0 percent of the annual average dollar volume of combined (single-family and multifamily) mortgages purchased by the respective GSE in the years 2000, 2001, and 2002. In addition, as a Special Affordable Housing Home Purchase Subgoal, 19 percent of the total number of home purchase mortgages in metropolitan areas financed by each GSE's mortgage purchases shall be home purchase mortgages in metropolitan areas which count toward the Special Affordable Housing Goal in each of those years unless otherwise adjusted by HUD in accordance with FHEFSSA.

* * * * *

6. Add § 81.15(i), to read as follows:

§ 81.15 General requirements.

* * * * *

(i) *Counting mortgages toward the Home Purchase Subgoals.* (1) *General.* The requirements of this section, except for paragraphs (b) and (e) of this section, shall apply to counting mortgages toward the Home Purchase Subgoals at §§ 81.12–81.14. However, performance under the Subgoals shall be counted using a fraction that is converted into a percentage for each Subgoal and the numerator of the fraction for each Subgoal shall be the number of home purchase mortgages in metropolitan areas financed by each GSE's mortgage purchases in a particular year that count towards achievement of the applicable housing goal. The denominator of each fraction shall be the total number of home purchase mortgages in metropolitan areas financed by each GSE's mortgage purchases in a particular year. For purposes of each Subgoal, the procedure for addressing missing data or information, as set forth in paragraph (d) of this section, shall be implemented using numbers of home purchase mortgages in metropolitan areas and not single-family owner-occupied dwelling units.

(2) *Special counting rule for mortgages with more than one owner-occupied unit.* For purposes of counting mortgages toward the Home Purchase Subgoals, where a single home purchase mortgage finances the purchase of two or more owner-occupied units in a metropolitan area, the mortgage shall count once toward each Subgoal that applies to the GSE's mortgage purchase.

7. Remove and reserve § 81.16(c)(1) and (c)(11).

8. Revise § 81.102 to read as follows:

§ 81.102 Verification and enforcement to ensure GSE data integrity.

(a) *Independent verification authority.* The Secretary may independently verify the accuracy and completeness of the data, information, and reports provided by each GSE, including conducting on-site verification, when such steps are reasonably related to determining whether a GSE is complying with 12 U.S.C. 4541'4589 and the GSE's Charter Act.

(b) *Certification.* The senior officer of each GSE who is responsible for submitting to HUD the AHAR under section 309(m) and (n) of the Fannie Mae Act or section 307(e) and (f) of the Freddie Mac Charter Act, as applicable, or for submitting to HUD such other report(s), data submission(s), or information for which certification is requested in writing by HUD (''GSE Certifying Official'') shall certify in connection with each such report(s), data submission(s) or information that:

(1) The GSE Certifying Official has reviewed the particular AHAR, other report(s), data submission(s) or information;

(2) To the best of the GSE Certifying Official's knowledge and belief, the particular AHAR, other report(s), data submission(s) or information are current, complete and do not contain any untrue statement of a material fact;

(3) To the best of the GSE Certifying Official's knowledge and belief, the particular AHAR, other report(s), data submission(s) or information fairly present in all material respects the GSE's performance, as required to be reported by section 309(m) or (n) of the

Fannie Mae Act or section 307(e) or (f) of the Freddie Mac Charter Act, or other applicable legal authority; and

(4) To the best of the GSE Certifying Official's knowledge and belief, the GSE has identified in writing any areas in which the GSE's particular AHAR, other report(s), data submission(s) or information may differ from HUD's written articulations of its counting rules including, but not limited to, the regulations under this part, and any other areas of ambiguity.

(c) *Adjustment to correct current year-end errors, omissions or discrepancies.* If HUD finds errors, omissions or discrepancies in a GSE's current year-end data submissions (including data reported in the GSE's AHAR under section 309(m) and (n) of the Fannie Mae Act or section 307(e) and (f) of the Freddie Mac Charter Act, as applicable) relative to HUD's regulations or other guidance, HUD will first notify the GSE by telephone or e-mail transmission of each such error, omission or discrepancy. The GSE must respond within five business days of such notification. If each error, omission or discrepancy is not resolved to HUD's satisfaction, HUD will then notify the GSE in writing and seek clarification or additional information to correct the error, omission or discrepancy. The GSE shall have 10 business days (or such longer period as HUD may establish, not to exceed 30 business days) from the date of this written notice to respond in writing to the request. If the GSE fails to submit a written response to HUD within this period, or if HUD determines that the GSE's written response fails to explain or correct each error, omission or discrepancy in its current year-end reported data to HUD's satisfaction, HUD will determine the appropriate adjustments to the numerator and the denominator of the applicable housing goal(s) and Subgoal(s). Should the Department determine that additional enforcement action against the GSE is warranted, it may pursue additional remedies under paragraph (e) of this section.

(d) *Adjustment to correct prior year reporting errors, omissions or discrepancies.*

(1) *General.* HUD may, in accordance with its authority in 12 U.S.C. 4566(a) to measure the extent of compliance with the housing goals, adjust a GSE's current year-end performance under a housing goal to deduct credit under the current goals and/or Subgoals to the extent caused by errors, omissions or discrepancies in a GSE's prior year's data submissions (including the AHAR under section 309(m) and (n) of the Fannie Mae Act or section 307(e) and (f) of the Freddie Mac Charter Act, as applicable) that result in an overstatement of GSE housing goal performance.

(2) *Applicability.* This paragraph applies to errors, omissions or discrepancies in a GSE's data submissions, including its AHAR, as provided in this section. It does not apply to the process applicable to HUD's review of current year performance, as described in paragraph (c) of this section.

(3) *Limitations.* This paragraph applies only to GSE reporting periods occurring on or after [effective date of final rule].

(4) *Procedural requirements.* In the event HUD determines that an adjustment to correct an error, omission or discrepancy in a GSE's prior year's data submissions (including data reported in the AHAR), as provided in paragraph (d)(1) of this section is warranted, it will provide the GSE with an initial letter containing its written findings and determinations within 24 months of the end of the relevant GSE reporting year. The GSE shall have an opportunity, not to exceed 30 days from the date of HUD's initial letter, to respond in writing, with supporting documentation, to contest the initial determination that there were errors in a prior year's data submissions (including the AHAR). HUD shall then issue a final determination letter within 60 days of the date of the GSE's written response. HUD may, upon a determination of good cause, extend the period for issuing a final determination letter by an additional 30 days.

(5) *Adjustments.* If the GSE failed to submit a written response to HUD's initial determination letter within the 30-day time period, or if, after reviewing a GSE's written response to the initial determination letter, HUD determines that a GSE's prior year's data submissions (including data reported in the AHAR as provided in paragraph (d)(1) of this section) resulted in an overstatement of its performance under one or more housing goals or Subgoals for a previous reporting period, HUD will direct the GSE to correct the overstatement by adjusting its level of performance under the applicable housing goal(s) and/or Subgoal(s) in the current year AHAR prior to submitting such report to HUD. The adjustment will be made by excluding the number of units or mortgages that HUD has determined were erroneously counted in a previous year from the numerator (but not the denominator) of each applicable housing goal and/or Subgoal. The GSE shall reflect the adjustment in its AHAR for the current year, as directed by HUD.

(6) *Effect of failure to meet a housing goal, or substantial probability of such failure.*

(i) *Procedural requirements.* In the event HUD determines that a GSE has failed, or that there is a substantial probability that the GSE will fail, to meet any housing goal(s) in the current reporting year as a result of an adjustment under paragraph (d) (5) of this section for previously overstated housing goals performance, HUD shall provide written notice to the GSE and otherwise comply with the procedural requirements set forth in 12 U.S.C. 4566(b).

(ii) *Remedies.* If HUD determines pursuant to 12 U.S.C. 4566(b) that a GSE has failed, or that there is a substantial probability that the GSE will fail, any housing goal(s) in the current reporting year as a result of an adjustment under paragraph (d) (5) of this section to correct for an overstatement of a prior year's goals performance, and that the achievement of the housing goal was or is feasible, it may pursue one or both of the following remedies:

(A) *Housing plan.* HUD may require the GSE to submit a housing plan for approval by the Secretary pursuant to 12 U.S.C. 4566(c) and § 81.22; and

(B) *Additional enforcement options.* HUD may, after complying with the procedural requirements set forth in subpart G of this part, seek a cease-and-desist order or civil money penalties against the GSE as described in paragraph (e) of this section.

(e) *Additional enforcement options.* (1) *General.* In the event the Secretary determines, either as a result of its independent verification authority described in paragraph (a) of this section or by other means, that the data submissions, information or report(s) submitted by a GSE to HUD pursuant to subpart E of this part, section 309(m) or (n) of the Fannie Mae Charter Act, or section 307(e) and (f) of the Freddie Mac Charter Act, as applicable, are not current, are incomplete or otherwise contain an untrue statement of material fact, the Secretary may regard this as equivalent to the GSE's failing to submit such data and, accordingly, may take the enforcement action authorized under paragraph (e)(2) of this section.

(2) *Remedies.* After HUD makes a final determination pursuant to paragraph (e) of this section that a GSE has submitted report(s), data submission(s) or information that are not current, are incomplete, or that contain untrue statement(s) of material fact, it may pursue any or all of the following remedies:

(i) HUD may obtain a cease-and-desist order against the GSE for failing to submit the report(s), data submission(s) or information, as applicable, required by subsection (m) or (n) of section 309 of the Fannie Mae Charter Act or subsection (e) or (f) of the Freddie Mac Charter Act, and as authorized by 12 U.S.C. 4581(a)(3), § 81.82, and subpart E of this part;

(ii) HUD may seek civil money penalties against the GSE for failing to submit the report(s), data submissions, or information, as applicable, required by subsection (m) or (n) of section 309 of the Fannie Mae Charter Act or subsection (e) or (f) of the Freddie Mac Charter Act, and as authorized by 12 U.S.C. 4585(a)(3), 24 CFR 81.83 and Subpart E of this part.

(iii) HUD may seek any other remedies or penalties against the GSE that may be available to the Secretary by virtue of the GSE's failure to provide data submissions, information and/or report(s) in accordance with the requirements of this section.

(3) *Procedures.* HUD shall comply with the procedures set forth in Subpart G of this part in connection with any enforcement action that it initiates against a GSE under this paragraph.

Dated: April 2, 2004.

John C. Weicher,

Assistant Secretary for Housing—Federal Housing Commissioner.

Note: The following appendices will not appear in the Code of Federal Regulations.

Appendix A—Departmental Considerations To Establish the Low- and Moderate-Income Housing Goal

A. Introduction

Sections 1 and 2 provide a basic description of the rule process. Section 3 discusses conclusions based on consideration of the factors.

1. Establishment of Low- and Moderate-Income Goal

In establishing the Low- and Moderate-Income Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), collectively referred to as the Government-Sponsored Enterprises (GSEs), Section 1332 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4562) (FHEFSSA) requires the Secretary to consider:

(1) National housing needs;

(2) Economic, housing, and demographic conditions;

(3) The performance and effort of the enterprises toward achieving the Low- and Moderate-Income Housing Goal in previous years;

(4) The size of the conventional mortgage market serving low- and moderate-income families relative to the size of the overall conventional mortgage market;

(5) The ability of the enterprises to lead the industry in making mortgage credit available for low- and moderate-income families; and

(6) The need to maintain the sound financial condition of the enterprises.

The Secretary also considered these factors in establishing a low- and moderate-income subgoal for home purchase loans on single-family-owner properties in metropolitan areas.

2. Underlying Data

In considering the statutory factors in establishing these goals, HUD relied on data from the 2001 American Housing Survey, the 2000 Censuses of Population and Housing, the 1991 Residential Finance Survey (RFS), the 1995 Property Owners and Managers Survey (POMS), other government reports, reports submitted in accordance with the Home Mortgage Disclosure Act (HMDA), and the GSEs. In order to measure performance toward achieving the Low- and Moderate-Income Housing Goal in previous years, HUD analyzed the loan-level data on all mortgages purchased by the GSEs for 1993–2002 in accordance with the goal counting provisions established by the Department in the December 1995 and October 2000 rules (24 CFR part 81).

3. Conclusions Based on Consideration of the Factors

The discussion of the first two factors covers a range of topics on housing needs and economic and demographic trends that are important for understanding mortgage markets. Information is provided which describes the market environment in which the GSEs must operate (for example, trends in refinancing activity). In addition, the severe housing problems faced by lower-income families are discussed, as are the barriers that minorities face when attempting to become homeowners. This discussion serves to provide useful background information for the discussion of the Underserved Areas and Special Affordable Housing Goals in Appendixes B and C, as well as for the Low- and Moderate-Income Housing Goal in this Appendix.

The third factor (past performance) and the fifth factor (ability of the GSEs to lead the industry) are also discussed in some detail in this Appendix. With respect to home purchase mortgages, the past performance of the GSEs and their ability to lead the industry are examined for all three housing goals; that analysis provides the basis for establishing the three subgoals for the GSEs' acquisitions of home loans on single-family-owner properties.

The fourth factor (size of the market) and the sixth factor (need to maintain the GSEs' sound financial condition) are mentioned only briefly in this Appendix. Detailed analyses of the fourth factor and the sixth factor are contained in Appendix D and in the economic analysis of this rule, respectively.

The factors are discussed in sections B through H of this appendix. Section I summarizes the findings and presents the Department's conclusions concerning the Low- and Moderate-Income Housing Goal. Section I also gives the rationale for a low- and moderate-income subgoal for home purchase loans.

The consideration of the factors in this Appendix has led the Secretary to the following conclusions:

- Changing population demographics will result in a need for primary and secondary mortgage markets to meet nontraditional credit needs, respond to diverse housing preferences, and overcome information and other barriers that many immigrants and minorities face. Growing housing demand from immigrants (both those who are already here and those projected to come) and non-traditional homebuyers will help to offset declines in the demand for housing caused by the aging of the population. Immigrants and other minorities—who accounted for nearly 40 percent of the growth in the nation's homeownership rate over the past five years—will be responsible for almost two-thirds of the growth in the number of new households over the next ten years. As these demographic factors play out, the overall effect on housing demand will likely be sustained growth and an increasingly diverse household population from which to draw new renters and homeowners.
- Despite the record national homeownership rate of 67.9 percent in 2002, much lower rates prevailed for minorities, especially for African-American households (47.9 percent) and Hispanics (48.2 percent), and these lower rates are only partly accounted for by differences in income, age, and other socioeconomic factors.
- In addition to low incomes, barriers to homeownership that disproportionately affect minorities and immigrants include lack of capital for down payments and closing costs, poor credit history, lack of access to mainstream lenders, little understanding of the home buying process, and continued discrimination in housing markets and mortgage lending.
- A HUD-published study of discrimination in the rental and owner markets found that while differential treatment between minority and white home seekers had declined over the past ten years, it continued at an unacceptable level in the year 2000. In addition, disparities in mortgage lending continued across the nation in 2002, when the loan denial rate was 7.8 percent for white mortgage applicants, but 20.1 percent for African Americans and 15.5 percent for Hispanics.[1]
- Americans with the lowest incomes face persistent housing problems. Recent HUD analysis reveals that in 2001, 5.1 million households had ''worst case'' housing needs, defined as housing costs greater than 50 percent of household income or severely inadequate housing among unassisted very-low-income renter households. Among these households, 90 percent had a severe rent burden, 6 percent lived in severely inadequate housing, and 4 percent suffered from both problems.

[1] Mortgage denial rates are based on 2002 HMDA data for home purchase loans; manufactured housing lenders are excluded from these comparisons.

• Over the past ten years, there has been a ''revolution in affordable lending'' that has extended homeownership opportunities to historically underserved households. Fannie Mae and Freddie Mac have been a substantial part of this ''revolution in affordable lending.'' During the mid-to-late 1990s, they added flexibility to their underwriting guidelines, introduced new low-down-payment products, and worked to expand the use of automated underwriting in evaluating the creditworthiness of loan applicants. HMDA data suggest that the industry and GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2002, conventional loans to low-income and minority families increased at much faster rates than loans to upper-income and non-minority families.

• The Low- and Moderate-Income Goal was set at 50 percent beginning in 2001. Effective on January 1, 2001, several changes in counting requirements came into effect, including (1) ''bonus points'' (double credit) for purchases of mortgages on small (5–50 unit) multifamily properties and, above a threshold level, mortgages on 2–4 unit owner-occupied properties; and (2) a ''temporary adjustment factor'' (1.35 unit credit) for Freddie Mac's purchases of mortgages on large (more than 50 units) multifamily properties. With these two counting rules, Fannie Mae's performance was 51.5 percent in 2001 and 51.8 percent in 2002, and Freddie Mac's performance was 53.2 percent in 2001 and 51.4 percent in 2002; thus, both GSEs surpassed this higher goal in both years.

• The bonuses and temporary adjustment factor expired at the end of 2003. Without these rules, Fannie Mae's performance would have been 51.3 percent in 2000, 49.2 percent in 2001, and 49.0 percent in 2002. Freddie Mac's performance would have been 50.6 percent in 2000, 47.7 percent in 2001, and 46.5 percent in 2002. Thus, both Fannie Mae and Freddie Mac would have surpassed the 50 percent goal in 2000 and fallen short in 2001 and 2002.

• This Appendix includes a comprehensive analysis of each GSE's performance in funding home purchase mortgages for borrowers and neighborhoods covered by the three housing goals—special affordable and low- and moderate-income borrowers and underserved areas. In addition, the role of the GSEs in the first-time homebuyer market is examined. While Freddie Mac has improved its affordable lending performance in recent years, it has consistently lagged the conventional conforming market in funding affordable home purchase loans for borrowers and neighborhoods targeted by the housing goals. However, Freddie Mac's recent performance (1999–2002) has been much closer to the market than its earlier performance.

• In general, Fannie Mae's affordable lending performance has been better than Freddie Mac's. But like Freddie Mac, Fannie Mae's average performance during past periods (*e.g.*, 1993–2002, 1996–2002, 1999–2002) has been below market levels. However, it is encouraging that Fannie Mae markedly improved its affordable lending performance relative to the market during 2001 and 2002, the first two years of HUD's higher housing goal levels. Fannie Mae's average performance during 2001 and 2002 approached the market on the special affordable and underserved areas categories and matched the market on the low-mod category. Under one measure of GSE and market activity, Fannie Mae matched the market during 2002 on the special affordable category and slightly outperformed the market on the low-mod and underserved areas categories. In this case, which is referred to in the text as the ''purchase year'' approach, Fannie Mae's performance is based on comparing its purchases of all loans (both seasoned loans and newly-originated mortgages) during a particular year with loans originated in the market in that year. When Fannie Mae's performance is measured on an ''origination year'' basis (that is, allocating Fannie Mae's purchases in a particular year to the year that the purchased-loan was originated), Fannie Mae matched the market in the low- and moderate-income category during 2002, and lagged the market slightly on the other two categories.

• Both Fannie Mae and Freddie lag the conventional conforming market in funding first-time homebuyers, and by a rather wide margin. Between 1999 and 2001, first-time homebuyers accounted for 27 percent of each GSE's purchases of home loans, compared with 38 percent for home loans originated in the conventional conforming market.

• The GSEs have accounted for a significant share of the total (government as well as conventional) market for home purchase loans, but their market share for each of the affordable lending categories (*e.g.*, low-income borrowers and census tracts, high-minority census tracts) has been less than their share of the overall market.

• The GSEs also account for a very small share of the market for important groups such as minority first-time homebuyers. Considering the total mortgage market (both government and conventional loans), it is estimated that the GSEs purchased only 14 percent of loans originated between 1999 and 2001 for African-American and Hispanic first-time homebuyers, or one-third of their share (42 percent) of all home purchase loans originated during that period. Considering the conventional conforming market and the same time period, it is estimated that the GSEs purchased only 31 percent of loans originated for African-American and Hispanic first-time homebuyers, or approximately one-half of their share (57 percent) of all home purchase loans in that market. The GSEs' small share of the first-time homebuyer market could be due to the preponderance of high (over 20 percent) downpayment loans in their mortgage purchases.

• This Appendix discusses the dynamic nature of the single-family mortgage market and the numerous changes that that this market has undergone over the past few years. Some important trends that will likely factor into the GSEs' performance in meeting the needs of underserved borrowers include the growth of the subprime market, the increasing use of automated underwriting systems, and the introduction of risk-based pricing into the market.

• The long run outlook for the multifamily rental market is sustained, moderate growth, based on favorable demographics. The minority population, especially Hispanics, provides a growing source of demand for affordable rental housing. ''Lifestyle renters'' (older, middle-income households) are also a fast-growing segment of the rental population. Provision of affordable housing, however, will continue to challenge suppliers of multifamily rental housing and policy makers at all levels of government. Low incomes combined with high housing costs define a difficult situation for millions of renter households. Housing cost reductions are constrained by high land prices and construction costs in many markets. Government action—through land use regulation, building codes, and occupancy standards—are major contributors to those high costs.

• The market for financing multifamily apartments has grown to record volumes. Fannie Mae and Freddie Mac have been among those boosting volumes and introducing new programs to serve the multifamily market. Fannie Mae's multifamily purchases jumped from about $10 billion in 1999 and 2000 to $18.7 billion during the heavy refinancing year of 2001, and $18.3 billion in 2002.

• Freddie Mac has re-entered the multifamily market, after withdrawing for a time in the early 1990s. Concerns regarding Freddie Mac's multifamily capabilities no longer constrain its performance with regard to the housing goals. Freddie Mac's multifamily purchases increased from a relatively low $3 billion in 1997 to approximately $7 billion during the next three years (1998 to 2000), before rising further to $11.9 billion in 2001 and $13.3 billion in 2002.

• The overall presence of both GSEs in the rental mortgage market falls short of their involvement in the single-family owner market. Between 1999 and 2002, the GSEs' purchases totaled for 57 percent of the owner market, but only 27 percent of the single-family rental market and 30 percent of the multifamily market. Certainly there is room for expansion of the GSEs in supporting the nation's rental markets, and that expansion is needed if the GSEs are to make significant progress in closing the gaps between the affordability of their mortgage purchases and that of the overall conventional conforming market.

• Considering both owner and rental properties, the GSEs' presence in the goals-qualifying market has been significantly less than their presence in the overall conventional conforming mortgage market. Specifically, HUD estimates that the GSEs accounted for 49 percent of all owner and rental units financed in the primary market between 1999 and 2002, but only 32 percent of units qualifying for the low-mod goal, 41 percent of units qualifying for the underserved areas goal, and 35 percent of units qualifying for special affordable goal.

B. Factor 1: National Housing Needs

This section reviews the general housing needs of lower-income families that exist today and are expected to continue in the near future. Affordability problems that lower-income families face in both the rental and owner markets are examined. The section also describes racial disparities in homeownership and the causes of these disparities. It also notes some special problems, such as the need to rehabilitate our older urban housing stock, that are discussed throughout this appendix.

1. Homeownership Gaps

Despite recent record homeownership rates, many Americans, including disproportionate numbers of racial and ethnic minorities, are shut out of homeownership opportunities. Although the national homeownership rate for all Americans stood at 68.3 percent at the end of 2003, the rate for minority households was lower—for example, just 48.5 percent of African-American households and 48.3 percent of Hispanic households owned a home. Differences in income and age between minorities and whites do not fully explain these gaps. The Joint Center for Housing Studies estimated that if minorities owned homes at the same rates as whites of similar age and income, a homeownership gap of 10 percentage points would still exist.[2]

a. Importance of Homeownership

Homeownership is one of the most common forms of property ownership as well as savings.[3] Historically, home equity has been the largest source of wealth for most Americans, and wealth gains in housing have been more widely distributed among the population than gains in the stock market.[4] With stocks appreciating faster than home prices over the past decade, home equity as a share of family assets fell from 38 percent in 1989 to 33 percent in 1998.[5] Many of the gains in the stock market were erased after 1999 however, and housing returned to its place as the most significant asset in the household balance sheet in 2001.[6] Even with a bull market through most of the 1990s, 59 percent of all homeowners in 1998 held more than half of their net wealth in the form of home equity.[7] Among low-income homeowners (household income less than $20,000), home equity accounted for about 72 percent of household wealth, and approximately 55 percent for homeowners with incomes between $20,000 and $50,000. Median net wealth for low-income homeowners under 65 was twelve times that of a similar renter.[8] Thus a homeownership gap continues to translate directly into a wealth gap.

High rates of homeownership support economic stability within housing and related industries, sectors that contributed nearly one-half of the total gain in real GDP in 2001.[9] In addition to economic benefits such as jobs and residential investment, studies show that the better living environment associated with owning a home has positive impacts on children, in terms of lower rates of teenage pregnancy and higher reading other test scores. The current literature substantiates that the benefits of homeownership extend beyond individual homeowners and their families to society at large. Homeownership promotes social and community stability by increasing the number of stakeholders and reducing disparities in the distributions of wealth and income. The empirical literature is generally supportive of a relationship between homeownership and greater investment in property.[10] Homeownership is also associated with neighborhood stability (lower mobility), greater participation in voluntary and political activities,[11] and links to entrepreneurship.[12]

b. Barriers to Homeownership [13]

Insufficient income, high debt burdens, and limited savings are obstacles to homeownership for younger families. As home prices skyrocketed during the late 1970s and early 1980s, real incomes also stagnated, with earnings growth particularly slow for blue collar and less educated workers. Through most of the 1980s, the combination of slow income growth and increasing rents made saving for home purchase more difficult, and relatively high interest rates required large fractions of family income for home mortgage payments. Thus, during that period, fewer households had the financial resources to meet down payment requirements, closing costs, and monthly mortgage payments.

Economic expansion and lower mortgage rates substantially improved homeownership affordability during the 1990s. Many young, low-income, and minority families who were closed out of the housing market during the 1980s re-entered the housing market during the last decade. Even with an economic slowdown in 2000–2001, improvements in affordability were seen in 2001 as lower interest rates and modest income growth reduced the average monthly mortgage payment from its year-ago level.[14] However, many households still lack the earning power to take advantage of today's home buying opportunities. Several trends have contributed to the reduction in the real earnings of young adults without college education over the last 15 years, including technological changes that favor white-collar employment, losses of unionized manufacturing jobs, and wage pressures exerted by globalization. Over 42 percent of the nation's population between the ages of 25 and 34 had no advanced education in 2000[15] and were therefore at risk of being unable to afford homeownership. African Americans and Hispanics, who have lower average levels of educational attainment than whites, are especially disadvantaged by the erosion in wages among less educated workers.

Immigrants and other minorities, who accounted for nearly 40 percent of the growth in the homeownership rate over the past five years, will be responsible for two-thirds of the growth in new households over the next ten years. These groups have unique housing needs and face numerous hurdles in becoming homeowners. In addition to low income, barriers to homeownership that disproportionately affect minorities and immigrants include:

- Lack of capital for down payment and closing costs;
- Poor credit history;
- Lack of access to mainstream lenders;
- Complexity and fear of the home buying process; and,
- Continued discrimination in housing markets and mortgage lending.

(i) *Lack of Cash for Down Payment.* In the 2002 Fannie Mae National Housing Survey, 40 percent of Hispanics reported not having enough money for a down payment as an obstacle to buying a home versus 32 percent of all Americans.[16] A study by Gyourko, Linneman, and Wachter found significant racial differences in homeownership rates in ''wealth-constrained'' households while finding no racial differences in homeownership rates among households with wealth sufficient to meet down payment and closing costs.[17] Minorities and immigrants are much less likely to receive gifts and inheritances from their parents to assist them in becoming a homeowner.

(ii) *Poor Credit History.* Poor credit history also differentially affects minority

[2] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2003,* 2003, p. 16.

[3] According to the National Association of Realtors, *Housing Market Will Change in New Millennium as Population Shifts,* November 7, 1998. Forty-five percent of U.S. household wealth was in the form of home equity in 1998. Since 1968, home prices have increased each year, on average, at the rate of inflation plus two percentage points

[4] Todd Buchholz, ''Safe At Home: The New Role of Housing in the U.S. Economy,'' a paper commissioned by the Homeownership Alliance, 2002.

[5] Federal Reserve Board, ''Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances,'' January 2000, p. 15.

[6] Mark Zandi, ''Housing's Rising Contribution,'' June 2002, p. 5.

[7] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 1998.*

[8] U.S Department of Housing and Urban Development, ''Economic Benefits of Increasing Minority Homeownership,'' p. 7.

[9] Mark Zandi, ''Housing's Rising Contribution,'' June 2002, p. 3.

[10] Robert Dietz and Donald Haurin, ''The Social and Private Consequences of Homeownership,'' May 2001, p. 51.

[11] William M. Rohe, George McCarthy, and Shannon Van Zandt, ''The Social Benefits and Costs of Homeownership,'' May 2000, p. 31.

[12] U.S. Department of Housing and Urban Development, ''Economic Benefits of Increasing Minority Homeownership,'' p. 8–9.

[13] For a discussion of the causes of existing disparities in homeownership, see the various articles in Nicolas P. Retsinas and Eric S. Belsky (Eds), *Low-Income Homeownership: Examining the Unexamined Goal,* Washington, D.C.: Brookings Institution Press, 2002.

[14] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2002*, p. 14.

[15] U.S. Census Bureau, *Current Population Survey,* March 2000.

[16] Fannie Mae, *Fannie Mae National Housing Survey*, 2002, p. 11.

[17] Joseph Gyourko, Peter Linneman, and Susan Wachter. ''Analyzing the Relationships among Race, Wealth, and Home Ownership in America,'' *Journal of Housing Economics* 8 (2), p. 63–89, as discussed in Thomas P. Boehm and Alan M. Schlottmann. ''Housing and Wealth Accumulation: Intergenerational Impacts,'' in *Low-Income Homeownership: Examining the Unexamined Goal*, Brookings Institution Press (2002), p. 408.

households. In the same Fannie Mae survey, nearly a third of African-American respondents said their credit rating would be an obstacle to buying a home versus 23 percent of all Americans.[18] Because African-American and Hispanic borrowers are more likely than others to have little traditional credit history or a poorer credit history, they face increased difficulties in being accepted for mortgage credit. This is because credit history scores (such as a FICO score) are a major component of the new automated mortgage scoring systems. These systems are more likely to refer minority borrowers for more intensive manual underwriting, rather than to automatically accept them for the less costly, expedited processing. In these situations, there is the additional concern that ''referred'' borrowers may not always receive a manual underwriting for the loan that they initially applied for, but rather be directed to a high-cost subprime loan product.

(iii) *Lack of Access to Mainstream Lenders.* Minorities face heightened barriers in accessing credit because of their often limited access to mainstream lenders. Access to lenders becomes difficult when mainstream financial institutions are not located in neighborhoods where minorities live. The growth in subprime lending over the last several years has benefited credit-impaired borrowers—those who may have blemishes in their credit record, insufficient credit history, or non-traditional credit sources. Subprime lenders have allowed these borrowers to access credit that they could not otherwise obtain in the prime credit market. However, studies by HUD, The Woodstock Institute and others have shown that subprime lending is disproportionately concentrated in low-income and minority neighborhoods.[19] While these studies recognize that differences in credit behavior explain some of the disparities in subprime lending across neighborhoods, they argue that the absence of mainstream lenders has also contributed to the concentration of subprime lending in low-income and minority neighborhoods. More competition by prime lenders in inner city neighborhoods could lower the borrowing costs of families who currently have only the option of a high-cost subprime loan. This issue of the lack of mainstream lenders in inner city neighborhoods is discussed further in subsection 2, below, in connection with disparities between neighborhoods.

(iv) *Complexity and Fear of Home Buying Process.* An additional barrier to homeownership is fear and a lack of understanding about the buying process and the risks of ownership. Many Americans could become homeowners if provided with information to correct myths, misinformation, and concerns about the mortgage process. Some potential homeowners, particularly minorities, are unaware that they may already qualify for a mortgage they can afford. The 2002 Fannie Mae survey revealed that 30 percent of Americans believe erroneously that they need to pay 20 percent of the cost of a home up-front. In addition, Fannie Mae reported that half of Americans are only ''somewhat'' or ''not at all'' comfortable with mortgage terms.[20] Freddie Mac reports that six of 10 Hispanics are uncomfortable with home buying terminology, and think they need ''perfect credit'' to buy; and less than four in 10 are aware that lenders are not required by law to give them the lowest interest rate possible.[21] A study using focus groups with renters found that even among those whose financial status would make them capable of homeownership, many felt that the buying process was insurmountable because they feared rejection by the lender or being taken advantage of.[22]

(v) *Discrimination in the Housing and Mortgage Markets.* Finally, differential treatment of minorities in the sales and rental markets and in the mortgage lending market has been well documented. The continued discrimination in these markets is discussed in the next section.

2. Disparities in Housing and Mortgage Markets

Sales and Rental Markets, In 2002, HUD released its third Housing Discrimination Study (HDS) in the sale and rental of housing. The study, entitled *Discrimination in Metropolitan Housing Markets: National Results from Phase I of The Housing Discrimination Study* was conducted by the Urban Institute.[23] The results of this HDS were based on 4,600 paired tests of minority and non-minority home seekers conducted during 2000 in 23 metropolitan areas nationwide. The report showed large decreases between 1989 and 2000 in the level of discrimination experienced by Hispanics and African Americans seeking to buy a home. There has also been a modest decrease in discrimination toward African Americans seeking to rent a unit. This downward trend, however, has not been seen for Hispanic renters, who now are more likely to experience discrimination in their housing search than do African-American renters. But while generally down since 1989, the report found that housing discrimination still exists at unacceptable levels. The greatest share of discrimination for Hispanic and African-American home seekers can still be attributed to being told units are unavailable when they are available to non-Hispanic whites, and being shown and told about fewer units than comparable non-minority home seekers. Although discrimination is down on most areas for African-American and Hispanic homebuyers, there remain worrisome upward trends of discrimination in the areas of geographic steering for African Americans and, relative to non-Hispanic whites, the amount of help agents provide to Hispanics with obtaining financing. On the rental side, Hispanics are more likely in 2000 than in 1989 to be quoted a higher rent than their white counterpart for the same unit.

Another HUD-sponsored study asked respondents to a nationwide survey if they ''thought'' they had ever been discriminated against when trying to buy or rent a house or an apartment.[24] While the responses were subjective, they are consistent with the findings of the HDS. African Americans and Hispanics were considerably more likely than whites to say they have suffered discrimination—24 percent of African Americans and 22 percent of Hispanics perceived discrimination, compared to only 13 percent of whites.

Mortgage Lending Market. Research based on Home Mortgage Disclosure Act (HMDA) data suggests pervasive and widespread disparities in mortgage lending across the Nation. For 2001, the mortgage denial rate for white mortgage applicants was 23 percent, while 36 percent of African-American and 35 percent of Hispanic applicants were denied.

Two recent HUD-sponsored studies of paired-testing at the mortgage pre-application stage also points to discrimination by mortgage lenders. Based on its review of pair tests conducted by the National Fair Housing Alliance, the Urban Institute concluded that differential treatment discrimination at the pre-application level occurred at significant levels in at least some cities.[25] Minorities were less likely to receive information about loan products, received less time and information from loan officers, and were quoted higher interest rates in most of the cities where tests were conducted. A second HUD-sponsored study by the Urban Institute used the paired testing methodology in Los Angeles and Chicago and found similar results. African Americans and Hispanics faced a significant risk of unequal treatment when they visited mainstream mortgage lending institutions to make pre-application inquiries.[26]

[18] Fannie Mae, *Fannie Mae National Housing Survey*, 2002, p. 11.

[19] See Dan Immergluck, *Stark Differences: The Explosion of the Subprime Industry and Racial Hypersegmentation in Home Equity Lending.* Woodstock Institute, October 2000; and Daniel Immergluck and Marti Wiles, *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development*, Woodstock Institute, Chicago, IL, November 1999. For a national analyses, see the HUD report *Unequal Burden: Income and Racial Disparities in Subprime Lending in America*, April 2000; and Randall M. Scheessele, *Black and White Disparities in Subprime Mortgage Refinance Lending*, Housing Finance Working Paper No. HF–114, Office of Policy Development and Research, U.S. Department of Housing and Urban Development, April 2002.

[20] Fannie Mae, *Fannie Mae National Housing Survey*, 2002, p. 9.

[21] See ''Immigration Changes Won't Hurt Housing,'' in *National Mortgage News*, January 27, 2003, page 8.

[22] Donald S. Bradley and Peter Zorn, ''Fear of Homebuying: Why Financially Able Households May Avoid Ownership,'' *Secondary Mortgage Markets*, 1996.

[23] Margery Austin Turner, Stephen L. Ross, George Galster, and John Yinger, ''Discrimination in Metropolitan Housing Markets,'' *The Urban Institute Press*, November 2002.

[24] Martin D. Abravanel and Mary K. Cunningham, *How Much Do We Know? Public Awareness of the Nation's Fair Housing Laws.* A report prepared for HUD by the Urban Institute, Washington, DC, April 2002.

[25] Margery Austin Turner, John Yinger, Stephen Ross, Kenneth Temkin, Diane Levy, David Levine, Robin Ross Smith, and Michelle deLair, *What We Know About Mortgage Lending Discrimination.* The Urban Institute, contract report for the Department of Housing and Urban Development, December 1998.

[26] Margery Austin Turner, *All Other Things Being Equal: A Paired Testing Study of Mortgage Lending Institutions*, The Urban Institute Press, April 2002.

Several possible explanations for these lending disparities have been suggested. A study by the Boston Federal Reserve Bank found that racial disparities cannot be explained by reported differences in creditworthiness.[27] In other words, minorities are more likely to be denied than whites with similar credit characteristics, which suggests lender discrimination. In addition, loan officers, who may believe that race is correlated with credit risk, may use race as a screening device to save time, rather than devote effort to distinguishing the creditworthiness of the individual applicant.[28] This violates the Fair Housing Act.

Underwriting rigidities may fail to accommodate creditworthy low-income or minority applicants. For example, under traditional underwriting procedures, applicants who have conscientiously paid rent and utility bills on time but have never used consumer credit would be penalized for having no credit record. Applicants who have remained steadily employed, but have changed jobs frequently, would also be penalized. As discussed in Section C below, lenders, private mortgage insurers, and the GSEs have been adjusting their underwriting guidelines to take into account these special circumstances of lower-income families. Many of the changes recently undertaken by the industry focused on finding alternative underwriting guidelines to establish creditworthiness that do not disadvantage creditworthy minority or low-income applicants. However, because of the enhanced roles of credit scoring and automated underwriting in the mortgage origination process, it is unclear to what degree the reduced rigidity in industry standards will benefit borrowers who have been adversely impacted by the traditional guidelines as discussed in section C.7, some industry observers have expressed a concern that the greater flexibility in the industry's written underwriting guidelines may not be reflected in the numerical credit and mortgage scores which play a major role in the automated underwriting systems that the GSEs and others have developed.

Disparities Between Neighborhoods. Mortgage credit also appears to be less accessible in low-income and high-minority neighborhoods. As discussed in Appendix B, 2001 HMDA data show that mortgage denial rates are nearly twice as high in census tracts with low-income and/or high-minority composition, as in other tracts (16.8 percent versus 8.7 percent). Numerous studies have found that mortgage denial rates are higher in low-income census tracts, even accounting for other loan and borrower characteristics.[29] These geographical disparities can be the result of cost factors, such as the difficulty of appraising houses in these areas because of the paucity of previous sales of comparable homes. Sales of comparable homes may also be difficult to find due to the diversity of central city neighborhoods. The small loans prevalent in low-income areas are less profitable to lenders because up-front fees to loan originators are frequently based on a percentage of the loan amount, although the costs incurred are relatively fixed. As noted above, racial disparities in mortgage access may be due to the fact that mainstream lenders are not doing business in certain inner city neighborhoods. There is evidence that mainstream lenders active in white and upper-income neighborhoods are much less active in low-income and minority neighborhoods—often leaving these neighborhoods to unregulated subprime lenders. Geographical disparities in mortgage lending are discussed further in Section C.8 below (which examines subprime lending) and in Appendix B (which examines the Underserved Areas Goal).

3. Affordability Problems and Worst Case Housing Needs

The severe affordability problems faced by low-income homeowners and renters are documented in HUD's ''Worst Case Housing Needs'' reports. These reports, which are prepared biennially for Congress, are based on the American Housing Survey (AHS), conducted every two years by the Census Bureau for HUD. The latest detailed report analyzes data from the 1999 AHS. Although it focuses on the housing problems faced by very-low-income renters, it also presents basic data on families and households in owner-occupied housing.[30]

The ''Worst Case'' report measures three types of problems faced by homeowners and renters:

1. Cost or rent burdens where housing costs or rent exceed 50 percent of income (a ''severe burden'') or range from 31 percent to 50 percent of income (a ''moderate burden'');
2. The presence of physical problems involving plumbing, heating, maintenance, hallway, or the electrical system, which may lead to a classification of a residence as ''severely inadequate'' or ''moderately inadequate;'' and,
3. Crowded housing, where there is more than one person per room in a residence.

The study reveals that in 1999, 4.9 million households had ''worst case'' housing needs, defined as housing costs greater than 50 percent of household income or severely inadequate housing among unassisted very-low-income renter households. Among the 34 million renters in all income categories, 6.3 million (19 percent) had a severe rent burden and over one million renters (3 percent) lived in housing that was severely inadequate.

a. Problems Faced by Owners

Of the 68.8 million owner households in 1999, 5.8 million (8 percent) confronted a severe cost burden and another 8.7 million (12.7 percent) faced a moderate cost burden. There were 870,000 households with severe physical problems, 2 million with moderate physical problems and 905,000 that were overcrowded. The report found that 25 percent of American homeowners faced at least one severe or moderate problem.

Not surprisingly, problems were most common among very low-income owners.[31] Almost a third of these households (31 percent) faced a severe cost burden, and an additional 22 percent faced a moderate cost burden. And 8 percent of these families lived in severely or moderately inadequate housing, while 2 percent faced overcrowding. Only 42 percent of very-low-income owners reported no problems.

Over time the percentage of owners faced with severe or moderate physical problems has decreased, as has the portion living in overcrowded conditions. However, affordability problems have become more common—the shares facing severe (moderate) cost burdens were only 3 percent (5 percent) in 1978, but rose to 5 percent (11 percent) in 1989 and 8 percent (13 percent) in 1999. The increase in affordability problems apparently reflects a rise in mortgage debt in the late 1980s and early 1990s, from 21 percent of homeowners' equity in 1983 to 36 percent in 1995.[32] The Joint Center for Housing Studies also attributes this to the growing gap between housing costs and the incomes of the nation's poorest households.[33] As a result of the increased incidence of severe and moderate cost burdens, the share of owners reporting no problems fell from 84 percent in 1978 to 78 percent in 1989 and 75 percent in 1999.

b. Problems Faced by Renters

Problems of all three types listed above are more common among renters than among homeowners. In 1999 there were 6.3 million renter households (19 percent of all renters) who paid more than 50 percent of their income for rent.[34] Another 7.1 million faced a moderate rent burden. Thus in total 40 percent of renters paid more than 30 percent of their income for rent.

Among very-low-income renters, 71 percent faced an affordability problem, including 40 percent who paid more than half of their income in rent. Almost one-third (31 percent) of renters with incomes between 51 percent and 80 percent of area median

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[27] Alicia H. Munnell, Geoffrey M.B. Tootell, Lynn E. Browne, and James McEneaney, ''Mortgage Lending in Boston: Interpreting HMDA Data,'' *American Economic Review*, 86, March 1996.

[28] See Charles W. Calomeris, Charles M. Kahn and Stanley D. Longhofer, ''Housing Finance Intervention and Private Incentives; Helping Minorities and the Poor,'' *Journal of Money, Credit and Banking*, 26, August 1994, pp. 634–74, for more discussion of this phenomenon, which is called ''statistical discrimination''

[29] Robert B. Avery, Patricia E. Beeson and Mark E. Sniderman, *Understanding Mortgage Markets: Evidence from HMDA*, Working Paper Series 94–21, Federal Reserve Bank of Cleveland, December 1994.

[30] HUD has published an update on ''worst case housing needs,'' which found that the number of such households rose from 4.86 million in 1999 to 5.07 million in 2001. However, detailed tables for 2001 have not been published.

[31] Very-low-income households are defined as those whose income, adjusted for household size, does not exceed 50 percent of HUD-adjusted area median income. This differs from the definition adopted by Congress in the GSE Act of 1992, which uses a cutoff of 60 percent and which does not adjust income for family size for owner-occupied dwelling units.

[32] Edward N. Wolff, ''Recent Trends in the Size Distribution of Household Wealth,'' *The Journal of Economic Perspectives*, 12(3), (Summer 1998), p. 137.

[33] Joint Center for Housing Studies, *The State of the Nation's Housing: 2000*, June 2000, p. 24.

[34] Rent is measured in this report as gross rent, defined as contract rent plus the cost of any utilities that are not included in contract rent.

family income also paid more than 30 percent of their income for rent.

Affordability problems have increased over time among renters. The shares of renters with severe or moderate rent burdens rose from 32 percent in 1978 to 36 percent in 1989 and 40 percent in 1999.

The share of households living in inadequate housing in 1999 was higher for renters (11 percent) than for owners (4 percent), as was the share living in overcrowded housing (5 percent for renters, but only 1 percent for owners). Crowding and inadequate housing were more common among lower-income renters, but among even the lowest income group, affordability was the dominant problem. The prevalence of inadequate and crowded rental housing diminished over time until 1995, while affordability problems grew.

Other problems faced by renters discussed in the most recent detailed ''Worst Case'' report include a sharp decline (of 2.3 million, or 14 percent) between 1991 and 1999 in the number of rental units affordable to very-low-income families, and a worsening of the national shortage of units affordable and available to extremely-low-income families (those with incomes below 30 percent of area median income). Shortages of units affordable and available to extremely-low-income households were most pressing in the West and Northeast, especially in metropolitan areas in those regions.

4. Rehabilitation and Other National Housing Needs

In addition to the broad housing needs discussed above, there are additional needs confronting specific sectors of the housing and mortgage markets. One example of these specific needs concerns the rehabilitation of the nation's older housing stock. A major problem facing lower-income households is that low-cost housing units continue to disappear from the existing housing stock. Older properties are in need of upgrading and rehabilitation. These aging properties are concentrated in central cities and older inner suburbs, and they include not only detached single-family homes, but also small multifamily properties that have begun to deteriorate. But obtaining the funds to fix up older properties can be difficult. The owners of small rental properties in need of rehabilitation may be unsophisticated in obtaining financing. The properties are often occupied, and this can complicate the rehabilitation process. Lenders may be reluctant to extend credit because of a sometimes-inaccurate perception of high credit risk involved in such loans. The GSEs and other market participants have recently begun to pay more attention to these needs for financing of affordable rental housing rehabilitation. However, extra effort is required, due to the complexities of rehabilitation financing, as there is still a need to do more.

The rehabilitation of our aging housing stock is but one example of the housing and mortgage issues that need to be addressed. Several other examples will be provided throughout the following sections on the economic, housing, and demographic conditions in the single-family and multifamily markets, as well as in Appendices B–D. The discussion will cover a wide range of topics, such as subprime lending, predatory lending, automated underwriting systems, manufactured housing, the special needs of the single-family rental market, and challenges associated with producing affordable multifamily housing—just to name a few.

C. Factor 2: Economic, Housing, and Demographic Conditions: Single-Family Mortgage Market

This section discusses economic, housing, and demographic conditions that affect the single-family mortgage market. After a review of housing trends and underlying demographic conditions that influence homeownership, the discussion focuses on specific issues related to the single-family owner mortgage market. This subsection includes descriptions of recent market interest rate trends, refinance and home purchase activity, homebuyer characteristics, and the state of affordable lending. Other special topics examined include the growth in subprime lending, the increased use of automated underwriting, and the remaining homeownership potential among existing renters. Section D follows with a discussion of the economic, housing, and demographic conditions affecting the mortgage market for multifamily rental properties.

1. Recent Trends in the Housing Market

While most other sectors of the economy were weak or declining during 2001 and 2002, the housing sector showed remarkable strength. Despite the recession in 2001, factors such as record-low interest rates and continued price stability contributed to a record year in the housing market. In 2002, the U.S. economy moved into recovery with real GDP growing 2.4 percent. In October 2002, the 30-year home mortgage rate slipped below 6 percent for the first time since the mid-1960s. Favorable financing conditions and solid increases in house prices were the key supports to another record housing market during 2002. In fact, the year 2002 was among the strongest years experienced by the housing industry. By the end of 2002 the industry set many new records in single-family permits, new home sales, existing home sales, interest rates, and homeownership. Other indicators—total permits, starts, completions, and affordability—reached levels that were among the highest in the past two decades.

Single-Family Permits, Starts, and Completions. Builders took out 1,319,100 single-family permits in 2002, up 6.8 percent from 2001. The 2002 level was the highest number of single-family permits ever reported in the 43-year history of this series. Single-family starts totaled 1,359,700 housing units, up 6.8 percent from 2001, and the highest number of single-family starts since 1978. Construction was completed on 1,328,400 single-family housing units, up 5.8 percent from 2001. This is the highest number of single-family completions in 24 years.

Sales of New and Existing Homes. After leveling out in 2000, housing sales have boomed in the past two years, reaching a record high in 2001 and again in 2002. New home sales, which increased an average 6.3 percent per year between 1992 and 2002, reached a record high of 976,000 units in 2002, an increase of 7.5 percent over 2001 sales. The market for new homes has been strong throughout the nation.

The National Association of Realtors reported that nearly 5.6 million existing homes were sold in 2002, overturning the old record set in 2001 by 5 percent, and setting an all-time high in the 34-year history of the series. Sales of existing homes reached record levels in three of the four major regions of the nation and came within 96 percent of the record in the Northeast in 2001. Combined new and existing home sales also set a national record of 6.2 million last year.

One of the strongest sectors of the housing market in past years had been manufactured homes, but that sector has declined recently. Between 1991 and 1996, manufactured home shipments more than doubled, peaking in 1998 at 373,000. However, shipments fell more than 20 percent in both 2000 and 2001. In 2002, the industry shipped 169,000 new manufactured homes, down 12.4 percent from 2001. This was the lowest number of manufactured home shipments since 1963.

Homeownership Rate. In 1980, 65.6 percent of Americans owned their own home, but due to the unsettled economic conditions of the 1980s, this share fell to 63.8 percent by 1989. But since 1994, gains in the homeownership rate have occurred in each year, with the rate reaching another record mark of 67.9 percent in 2002. The number of households owning their own home in 2002 was 10.6 million greater than in 1994.

Gains in homeownership have been widespread over the last eight years.[35] As a result, the homeownership rate rose from:

- 42.0 percent in 1993 to 47.9 percent in 2002 for African-American households,
- 39.4 percent in 1993 to 48.2 percent in 2002 for Hispanic households,
- 73.7 percent in 1993 to 78.9 percent in 2002 for married couples with children,
- 65.1 percent in 1993 to 68.6 percent in 2002 for household heads aged 35–44, and
- 48.9 percent in 1993 to 51.8 percent in 2002 for central city residents.

However, as these figures demonstrate, sizable gaps in homeownership remain.

Economy/Housing Market Prospects. The economy grew at a rate of 2.2 percent in 2002 and was less robust than in past U.S. recoveries.[36] In response, the Federal Reserve has lowered interest rates to record lows, supporting housing affordability.

The Blue Chip consensus forecast for real GDP growth is 4.2 percent for 2004.[37] The Congressional Budget Office (CBO)[38] projects

[35] Homeownership rates prior to 1993 are not strictly comparable with those beginning in 1993 because of a change in weights from the 1980 Census to the 1990 Census.

[36] National Association of Realtors, ''Near Record Home Sales Projected for 2003,'' December 3, 2002.

[37] *Blue Chip Economic Indicators,* Vol. 28, No. 11, November 10, 2003.

[38] Real GDP, unemployment, inflation, and treasury note interest rate projections are obtained for fiscal years 2003–2013 from The Budget and Economic Outlook: An Update, Washington, DC Congressional Budget Office. (August 2003). *http://www.cbo.gov/showdoc.cfm.*

that real GDP will grow at an average rate of 3.3 percent from 2005 through 2008, down from their forecasted rate of 3.8 percent in 2004. Inflation, as measured by the Consumer Price Index (CPI), is projected to remain modest during the same period, averaging 2.5 percent. The unemployment rate is expected to ease from 2003–2004 levels, averaging 5.4 percent over the forecast period. The remainder of this subsection focuses on future prospects for the housing market.

Fannie Mae expects existing home sales to reach a record level of 6 million in 2003 and decline only slightly to 5.7 million in 2004 and 2005.[39] Projected at 1.84 million in 2003, the National Association of Home Builders expects housing starts to decline to 1.77 million in 2004 and 1.71 million in 2005.[40] The Mortgage Bankers Association forecasts that 2004 housing starts will total 1.73 million units and the 30-year fixed mortgage rate will average 6.1 percent.[41] After more than doubling from a relative trough in 2000 to an estimated $2.6 trillion in 2002, Fannie Mae forecasts that mortgage originations will rise to a record high $3.7 trillion in 2003 before dropping to $1.8 trillion in 2004 and $1.5 trillion in 2005.[42]

2. Underlying Demographic Conditions

Between 2000 and 2025, the U.S. population is expected to grow by an average of 2.5 million per year.[43] This will likely result in 1.1 million new households per year, increasing the number of households 26 percent in the period, and creating a continuing need for additional housing.[44] This section discusses important demographic trends behind these overall household numbers that will likely affect housing demand in the future. These demographic forces include the baby-boom, baby-bust and echo baby-boom cycles; immigration trends; non-traditional and single households; ''trade-up buyers;'' and the growing income inequality between people with different levels of education. HUD's Office of Policy Development and Research funded a study, *Issue Papers on Demographic Trends Important to Housing*, which analyzes effects of demographic conditions on the housing market. The findings are presented throughout the sections that follow.[45]

As explained below, the role of traditional first-time homebuyers, 25-to-34 year-old married couples, in the housing market will be smaller in the current decade due to the aging of the population. For the first time in history, the population will have roughly equal numbers of people in every age group. Between 2000 and 2025, the Census Bureau projects that the largest growth in households will occur among householders 65 and over.[46] Thus, an increasing percentage of the population will be past their homebuying peak in the next two decades. However, because homeownership rates do not peak until population groups reach 65 to 74 years of age, this age cohort will continue to provide housing demand. According to Riche, the increasing presence of older households should increase the proportion of the population that owns, rather than rents housing.[47]

Growing housing demand from immigrants and non-traditional homebuyers will help to offset declines in the demand for housing caused by the aging of the population. Riche's study estimates that minorities will account for two-thirds of the growth in U.S. households over the next 25 years, and by 2025, non-family households will make up a third of all households. The ''echo baby-boom'' (that is, children of the baby-boomers) will also add to housing demand in the current and next decades. Finally, the growing income inequality between people with and without a post-secondary education will continue to affect the housing market.

The Baby-Boom Effect. The demand for housing during the 1980s and 1990s was driven, in large part, by the coming of homebuying age of the baby-boom generation, those born between 1945 and 1964. Homeownership rates for the oldest of the baby-boom generation, those born in the 1940s, rival those of the generation born in the 1930s. Due to significant house price appreciation in the late-1970s and 1980s, older baby-boomers have seen significant gains in their home equity and subsequently have been able to afford larger, more expensive homes. Circumstances were not so favorable for the middle baby-boomers. Housing was not very affordable during the 1980s, their peak homebuying age period. As a result, the homeownership rate, as well as wealth accumulation, for the group of people born in the 1950s lags that of the generations before them.[48]

As the youngest of the baby-boomers (those born in the 1960s) reached their peak home buying years in the 1990s, housing became more affordable. While this cohort has achieved a homeownership rate equal to the middle baby-boomers, they live in larger, more expensive homes. As the baby-boom generation ages, demand for housing from this group is expected to wind down.[49]

The baby-boom generation was followed by the baby-bust generation, from 1965 through 1977. Since this population cohort is smaller than that of the baby boom generation, it reduced housing demand in the preceding decade and is expected to do the same in the current decade, though, as discussed below, other factors kept the housing market very strong in the 1990s. However, the echo baby-boom generation (the children of the baby-boomers, who were born after 1977), while smaller than the baby-boom generation, will reach peak home buying age later in the first decade of the millennium.

Immigrant Homebuyers. Past, present, and future immigration will also contribute to gains in the homeownership rate. During the 1990s, 9.8 million legal immigrants entered the United States, as compared to 6.3 million entering in the 1980s and 4.2 million during the 1970s. Overall, the increase in the immigrant population directly accounted for 35 percent of the nation's rise in population in the 1990s.[50] As a result, the foreign-born population of the United States more than tripled from 9.6 million in 1970 to 31.1 million in 2000. Immigrants who become citizens buy homes at rates nearly as high as their same-aged native-born counterparts. Moreover, U.S.-born children of immigrants often have higher homeownership rates than the same-age children of native-born parents.[51] However, there are concerns about the assimilation into homeownership of recent Hispanic immigrants who are less educated than earlier cohorts of immigrants. Many immigrants also locate in high-priced housing markets, which makes it more difficult for them to achieve homeownership.

Although net foreign immigration is projected to decline in the current decade after 2002, high levels of immigration in the late 1980s and throughout the 1990s will have lasting positive effects on housing demand. New immigration in the current and next decades is projected to create 6.9 million net new households, but the majority of household growth in the period (16.9 million) will come from people already resident in the U.S. including the foreign-born population.[52] While immigrants tend to rent their first homes upon arriving in the United States, homeownership rates are substantial for those that have lived here for at least 6 years. In 1996, the homeownership

[39] Fannie Mae, ''Berson's Economic and Mortgage Market Development Outlook,'' December 2003. *http://www.fanniemae.com/media/pdd/berson/monthly2003/121203.pdf.*

[40] *http://www.nahb.org.*

[41] Mortgage Bankers Association of America, Mortgage Finance Forecast, December 17, 2003. *http://www.mbaa.org/marketdata/forecasts/mffore1103.pdf.*

[42] Fannie Mae, ''Berson's Economic and Mortgage Market Development Outlook,'' December 2003.

[43] U.S. Census Bureau, Population Projections Table NP–T1.

[44] Martha Farnsworth Riche, ''How Changes in the Nation's Age and Household Structure Will Reshape Housing Demand in the 21st Century,'' in *Issue Papers on Demographic Trends Important to Housing,* Urban Institute Final Report to the Office of Policy Development and Research, U.S. Department of Housing and Urban Development, September 2002, p. 5.

[45] Barry Chiswick, Paul Miller, George Masnick, Zhu Xiao Di, and Martha Farnsworth Riche, *Issue Papers on Demographic Trends Important to Housing.* Urban Institute Final Report to the Office of Policy Development and Research, U.S. Department of Housing and Urban Development, September 2002.

[46] Martha Farnsworth Riche, ''How Changes in the Nation's Age and Household Structure Will Reshape Housing Demand in the 21st Century,'' in *Issue Papers on Demographic Trends Important to Housing.* Urban Institute Final Report to the U.S. Department of Housing and Urban Development, September 2002, p. 4.

[47] *Ibid.* p. 6.

[48] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 1998,* p. 14.

[49] *Ibid.* p. 15.

[50] Federation for American Immigration Reform, <*http://www.fairus.org/html/042us604.htm#ins*>, site visited December 13, 2002.

[51] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2002,* pp. 16–17.

[52] George S. Masnick and Zhu Xiao Di, ''Projections of U.S. Households By Race/Hispanic Origin, Age, Family, Type, and Tenure to 2020: A Sensitivity Analysis,'' in *Issue Papers on Demographic Trends Important to Housing.* Urban Institute Final Report to the U.S. Department of Housing and Urban Development, September 2002, p. 5.

rate for recent immigrants was 14.7 percent while it was 66.9 percent for foreign-born naturalized citizens after six years.[53] Higher-than-average foreign-born fertility rates and high rates of homeownership for immigrants living in the country for several years and among the children of immigrants suggest that past immigration will continue to create housing demand.

Past and future immigration will lead to increasing racial and ethnic diversity, especially among the young adult population. As immigrant minorities account for a growing share of first-time homebuyers in many markets, HUD and others will have to intensify their focus on removing discrimination from the housing and mortgage finance systems. The need to meet nontraditional credit needs, respond to diverse housing preferences, and overcome the information barriers that many immigrants face will take on added importance. In order to address these needs, the mortgage industry must offer innovative products and improve outreach efforts to attract minority homebuyers.

Nontraditional and Single Homebuyers. While overall growth in new households has slowed down, nontraditional households have become more important in the homebuyer market. As the population ages both relatively and absolutely, the nation's households will become smaller and more diverse. Riche notes that in 2000, traditional family households represented fewer than one in four households and were surpassed by both single-person households and married couples without children. With later marriages and more divorces, single-parent and single-person households have increased rapidly. In fact, single-parent households grew from 4 percent of family households in 1950 to 12 percent in 2000. Single-person households are now the nation's second most numerous household type, accounting for over 25 percent of all households. In the future, longer life expectancies and the continuing preference for one or two children will make households without children even more numerous. Projected to compose 80 percent of all households by 2025, nontraditional family households will play an increasingly important role in the housing market.[54]

Trade-up Buyers. Due to weak house price appreciation, traditional ''trade-up buyers'' stayed out of the market during the early 1990s. Their absence may explain, in part, the large representation of nontraditional homebuyers during that period. However, since 1995 home prices have increased more than 30 percent.[55] The greater equity resulting from recent increases in home prices should lead to a larger role for ''trade-up buyers'' in the housing market during the next 10 to 15 years. In addition, the growing number of higher-income, mid-life households will increase households' potential to ''trade up'' to more expensive housing.[56]

Growing Income Inequality. The Census Bureau recently reported that the top 5 percent of American households received 22.4 percent of aggregate household income in 2001, up from 21.4 percent in 1998 and up sharply from 16.1 percent in 1977. The share accruing to the lowest 80 percent of households fell from 56.5 percent in 1977 to 50.8 percent in 1998 and again to 49.8 percent in 2001. The share of aggregate income accruing to households between the 80th and 95th percentiles of the income distribution was virtually unchanged from 1977 to 2001.[57]

The increase in income inequality over past decades has been especially significant between those with and those without post-secondary education. The Census Bureau reports that by 1999, the annual earnings of workers with a bachelor's degree were 1.8 times the annual earnings of workers with a high school education.[58] The inflation-adjusted median earnings of high school graduates were at the same level in 2001 as in 1991 while the earnings of bachelor degree-holders rose nearly 9 percent over the same period.[59]

So, while homeownership is highly affordable, those without post-secondary education often lack the financial resources to take advantage of the opportunity. As discussed earlier, the days of the well-paying unionized factory job have passed. They have given way to technological change that favors white-collar jobs requiring college degrees, and wages in the manufacturing jobs that remain are experiencing downward pressures from economic globalization. The effect of this is that workers without the benefit of a post-secondary education find their demand for housing constrained. This is especially problematic for recent immigrants who are more likely to have limited educational attainment and English language proficiency.

Summary. Over the next two-and-a-half decades, the number of U.S. households is projected to increase by nearly 27 million. Of these new households, non-Hispanic white and traditional households will contribute only one-third and one-tenth of the growth, respectively. As the baby-boomers aged out of their peak home buying stage and the baby-bust generation aged into their peak home buying stage in the late 1980s, demand for housing was dampened by demographic factors during the 1990s. (Of course, other factors such as low interest rates propelled the housing market to record levels during this period.) As the echo baby-boomers begin to enter their peak home buying age, housing demand should pick up again through the remainder of the current decade and into the next. As these demographic factors play out, the overall effect on housing demand will likely be sustained growth and an increasingly diverse household population from which to draw new homeowners. There are continuing concerns about the increasing income inequality of our population and those recent immigrants and other persons who have limited education.

3. Basic Trends in the Single-Family Mortgage Market

Mortgage lending in the nation is growing at unprecedented levels. Residential mortgage originations soared to $2.5 trillion in 2002, a 22 percent increase over the previous record of $2.06 trillion set in 2001.[60] This boom in lending can be attributed to low mortgage interest rates and a record number of refinances. Approximately 40 percent of mortgage debt outstanding, or $2.5 trillion, was refinanced during the 2001–02 refinance boom. The last refinancing record was set in 1998 when roughly 20 percent of mortgage debt outstanding was refinanced.[61] This section focuses on recent interest rate trends, the refinance market, the home purchase market, and first-time homebuyers. The section concludes by examining the GSEs' acquisitions as a share of the primary single-family mortgage market, and provides mortgage market prospects.

a. Mortgage Characteristics

Interest Rate Trends and Volatility. Historically low mortgage interest rates in the late 1990s and 2001–2003 helped maintain consumer confidence in the housing sector as the economy emerged from its first recession in almost a decade. After high and fluctuating mortgage rates in the 1980s and early 1990s, recent years have seen a period of lower and more stable rates. The 1980s began with interest rates on mortgages for new homes above 12 percent but quickly rose to more than 15 percent.[62] By 1987–88, rates dipped into single digits but were rising again by 1989–90. Rates declined in the early 1990s, reaching a low of 6.8 percent in late 1993. An upturn in rates in 1994 and 1995 peaked at 8.3 percent in early 1995. By 1998, 30-year fixed conventional mortgages averaged 6.95 percent, the lowest level since 1968 but saw a rise in 1999 to 7.44 percent. Mortgage rates then continued to rise in 2000, averaging 8.05 percent for the year, before falling to a low of 6.62 percent in October 2001 and averaging 6.97 percent for 2001 as a whole.[63] Rates averaged 6.54 percent during 2002, reaching a low of 6.05

[53] Fred Flick and Kate Anderson, ''Future of Housing Demand: Special Markets,'' *Real Estate Outlook,* 1998, p. 6.

[54] Riche, 2002, p. 1.

[55] Average new-home price: U.S. Census Bureau, <*http://www.census.gov/const/uspriceann.pdf*>

[56] Riche, 2002, p.17.

[57] All data in this paragraph are from the U.S. Census Bureau's Historical Income Table H2.

[58] Jennifer Cheeseman Day and Eric C. Newburger, *The Big Payoff: Educational Attainment and Synthetic Estimates of Work-Life Earnings,* U.S. Bureau of the Census, Current Population Reports P23–210, July 2002, p.3.

[59] U.S. Census Bureau, Historical Income Table H13.

[60] ''Mortgage Originations Hit Record-Busting $2.5 Trillion in 2002, IMF Numbers Reveal,'' *Inside Mortgage Finance,* January 24, 2003, p. 3.

[61] Economy.com, ''The Economic Contribution of the Mortgage Refinancing Boom,'' December 2002, p. 2.

[62] Interest rates in this section are effective rates paid on conventional home purchase mortgages on new homes, based on the Monthly Interested Rate Survey (MIRS) conducted by the Federal Housing Finance Board and published by the Council of Economic Advisers annually in the *Economic Report of the President* and monthly in *Economic Indicators.* These are average rates for all loan types, encompassing 30-year and 15-year fixed-rate mortgages and adjustable rate mortgages.

[63] *U.S. Housing Market Conditions, 2nd Quarter 2002,* August 2002, Table 14.

percent in December of that year. Falling further to 5.23 in June of 2003, mortgage interest rates remained low throughout last year, averaging 5.79 through September.[64]

Other Loan Terms. When mortgage rates are low, most homebuyers prefer to lock in a fixed-rate mortgage (FRM). Adjustable-rate mortgages (ARMs) are more attractive when rates are high, because they carry lower rates than FRMs and because buyers may hope to refinance to a FRM when mortgage rates decline. The Federal Housing Finance Board (FHFB) reports that the ARM share of the market fell from 20 percent in 1993 to a record low of 12 percent in 1998, before rising back to 21 percent in 1999. The ARM share continued to rise to 24 percent in 2000, but then fell dramatically to a low of 12 percent in 2001 as mortgage rates decreased.

In 2001, the term-to-maturity was 30 years for 83 percent of conventional home purchase mortgages, after steadily climbing to a high of 90 percent in 2000. The other maturities in 2001 included 15 years (13 percent), 20 years (3 percent), and 25 years (1 percent).

Low- and no-point mortgages continue to be a popular option for mortgage purchases. FHFB reports that average initial fees and charges (''points'') have decreased from 2.5 percent of loan balance in the mid-1980s to 2 percent in the late-1980s, 1.5 percent in the early 1990s, and less than 1 percent in 1995–97. The downward trend continued throughout the late 1990s with the average initial fees and charges reaching a low of one-half percent in 2001. Coupled with declining interest rates, these lower transactions costs have increased the propensity of homeowners to refinance their mortgages.[65]

Another major change in the conventional home mortgage market has been the proliferation of high loan-to-value ratio (LTV) mortgages. According to data from the Federal Housing Finance Board, loans with LTVs greater than 90 percent (that is, down payments of less than 10 percent) made up less than 10 percent of the market in 1989–91, but 25 percent of the market in 1994–97, gradually decreasing to an average of 21 percent of the market in 2001. Loans with LTVs less than or equal to 80 percent fell from three-quarters of the market in 1989–91 to an average of 56 percent of the market in 1994–97, but then rose to an average of 63 percent of mortgages originated in 1998–2001. As a result, the average LTV rose from 75 percent in 1989–91 to nearly 80 percent in 1994–97, and then declined to 76.2 percent in 2001.[66]

b. Refinance Mortgages

Refinancing has fueled the growth in total mortgage originations, which were $638 billion in 1995 (a period of low refinance activity), but topped $2.5 trillion in 2002 (a period of heavy refinance activity). The refinance share of total mortgage originations rose to 50 percent in 1998, then decreased to 19 percent in 2000 before jumping to 57 percent in 2001.[67] Over the past ten years, refinance booms occurred three times, during 1992–93, 1998, and 2001–02. During the 2001–02 refinance boom, approximately 40 percent of the $2.5 trillion in mortgage debt outstanding was refinanced. The last refinancing record was set in 1998 when roughly 20 percent of mortgage debt outstanding was refinanced.[68]

In 1989–90 interest rates exceeded 10 percent, and refinancings accounted for less than 25 percent of total mortgage originations.[69] The subsequent sharp decline in mortgage rates drove the refinance share over 50 percent in 1992 and 1993 and propelled total single-family originations to more than $1 trillion in 1993—twice the level attained just three years earlier.

The refinance wave subsided after 1993, because most homeowners who found it beneficial to refinance had already done so and because mortgage rates rose once again.[70] Total single-family mortgage originations bottomed out at $638 billion in 1995, when the refinance share was only 21 percent. Total originations, driven by the volume of refinancings, amounted to $1.507 trillion in 1998, nearly 50 percent higher than the previous record level of $1.02 trillion attained in 1993.

The refinance wave from late 1997 through early 1999 reflected other factors besides interest rates, including greater borrower awareness of the benefits of refinancing, a highly competitive mortgage market, and the enhanced ability of the mortgage industry, utilizing automated underwriting and mortgage origination systems to handle an unprecedented volume of originations. The refinance share decreased to 19 percent in 2000 before jumping to a record 57 percent in 2001.

Historically low interest rates and declining mortgage transaction costs have driven the latest refinancing boom. Given these conditions, the after-tax cost saving on a new, lower-rate loan is much greater than the transaction costs of refinancing. In addition, the appreciation of housing prices has also contributed to the increase in refinancing. Over the past five years, the value of housing rose by approximately $5 trillion, and the rise in value has enabled lenders to service refinancing homeowners because of greater confidence in the creditworthiness of borrowers.[71]

Over the past few years, homeowners have become more willing to draw on the rising equity in their homes. According to Fannie Mae's 2002 National Housing Survey, homeowners that refinanced during 2001 withdrew about $110 billion in accumulated home equity wealth.[72] Freddie Mac estimates that more than one-half of all refinance mortgages in the past two years involved cash-out refinancing.[73]

The refinancing boom contributed to an estimated one-fifth of the national economy's real GDP growth since late 2000.[74] During 2001 and 2002, roughly $270 billion was raised in cash-out refinancing. Approximately one-half of cash from cash-out refinancing has enabled consumers to finance more spending for expenses such as home improvements, medical payments, education, and vehicles during a weakened economy. Roughly one-third of the cash from cash-out refinancing has allowed consumers to repay other debt.[75] The remaining cash from cash-out refinancing has enabled consumers to invest in other assets. Refinancing households save approximately $10 billion in their annual interest payments on their mortgage and consumer installment liabilities.

Although the refinancing boom may quickly fade if mortgage rates rise in 2004, the boom will have lingering effects. Mortgage borrowers that were able to secure low long-term interest rates through fixed rate mortgages will have more of their budgets to spend on other items. Meanwhile, cash-out borrowers, who are just receiving their money, will spend this year. It must be noted there is some concern regarding the potential for increased credit risk stemming from mortgage debt from cash out borrowers. According to a 2002 Regional Finance Review article, the mortgage liabilities of households have been growing at a rate more than double the growth in household incomes. However, this potential credit risk is moderated by the strong growth in housing values. The ratio of mortgage debt to housing

[64] Mortgage Bankers Association website. MBA Weekly Survey of Mortgage Applications, Monthly Average Interest Rates on 30-Year Fixed-Rate Mortgages. *http://www.mortgagebankers.org/marketdata/index.html.*

[65] This is discussed in more detail in Paul Bennett, Richard Peach, and Stavros Peristani, *Structural Change in the Mortgage Market and the Propensity to Refinance*, Staff Report Number 45, Federal Reserve Bank of New York, September 1998.

[66] Other sources of data on loan-to-value ratios such as the American Housing Survey and the Chicago Title and Trust Company indicate that high-LTV mortgages are somewhat more common in the primary market than the Finance Board's survey. However, the Chicago Title survey does not separate FHA-insured loans from conventional mortgages. In addition, the statistics cited above pertain only to home purchase mortgages. Refinance mortgages generally have shorter terms and lower loan-to-value ratios than home purchase mortgages.

[67] The source for the refinance share and total mortgage originations was the Mortgage Bankers Association.

[68] Economy.com, ''The Economic Contribution of the Mortgage Refinancing Boom,'' December 2002, p. 2.

[69] Refinancing data is taken from Freddie Mac's monthly *Primary Mortgage Market Survey.*

[70] There is some evidence that lower-income borrowers did not participate in the 1993 refinance boom as much as higher-income borrowers—see Paul B. Manchester, *Characteristics of Mortgages Purchased by Fannie Mae and Freddie Mac: 1996–97 Update*, Housing Finance Working Paper No. HF–006, Office of Policy Development and Research, Department of Housing and Urban Development, August 1998, pp. 30–32.

[71] Economy.com, ''The Economic Contribution of the Mortgage Refinancing Boom,'' December 2002, p. 4.

[72] Fannie Mae, *2002 Fannie Mae National Housing Survey*. <http://www.fanniemae.com/global/pdf/media/survey/survey2002>, September 4, 2002, p. 2.

[73] Economy.com, ''The Economic Contribution of the Mortgage Refinancing Boom,'' December 2002, p. 4.

[74] Mark M. Zandi, ''Refinancing Boom,'' *Regional Finance Review*, December 2002, p. 11.

[75] *Ibid.* p. 14.

values, the aggregate loan-to-value ratio, has remained fairly stable for a decade.[76]

c. Home Purchase Mortgages

The volume of home purchase mortgages was $505 billion in 1995, rose to $848 billion in 1999, and remained in the $829–$873 billion range between 1999–2001 before jumping to $1.02 trillion in 2002 and $1.30 trillion in 2003. The Mortgage Bankers Association (MBA) forecasts that the home purchase volume will be $1.34 trillion in 2004 as the home purchase share rises to 54 percent of all originations.[77] The home purchase share of total mortgage originations was 79 percent in 1995, declined to 50 percent in 1998, rose to 81 in 2000, and sharply fell to 43 percent in 2001, 41 in 2002, and 34 percent in 2003, as refinance mortgage volume grew. This section discusses the important issue of housing affordability and then examines the value of homeownership as an investment.

The National Association of Realtors (NAR) has developed a housing affordability index, calculated as the ratio of median household income to the income needed to qualify for a median price home (the latter income is called the ''qualifying income''). In 1993, NAR's affordability index was 133, which meant that the median family income of $37,000 was 33 percent higher than that income needed to qualify for the median priced home. Housing affordability remained at about 130 for 1994–97, with home price increases and somewhat higher mortgage rates being offset by gains in median family income.[78] Falling interest rates and higher income led to an increase in affordability to 143 in 1998, reflecting the most affordable housing in 25 years. Affordability remained high in 1999, despite the increase in mortgage rates. NAR's affordability index declined from 140 in 1999 to 129 in 2000 as mortgage rates increased. The index turned upward to 136 in 2001 as mortgage rates fell and maintained this average in 2002, before rising further to 140 in 2003.[79]

Although the share of home purchase loans for lower-income households and/or households living in lower-income communities increased over the past decade, affordability still remains a challenge for many. The median sales price of existing single-family homes in the United States continues to rise, reaching $158,100 in 2002 and $170,000 in 2003. The production of affordable housing and low interest rates could offset the negative impact of rising house prices, which undermine housing affordability for many Americans, particularly in several high-cost markets on the east and west coasts.

As discussed earlier, barriers are preventing many potential homeowners from becoming homeowners, thus reducing the possible amount of home purchase loans. While the strong housing sector has provided financial security for many Americans, a 2002 Fannie Mae survey found that ''information barriers still keep many financially qualified families-particularly minority Americans from becoming homeowners or obtaining the lowest-cost financing available to them.''[80]

These homeownership barriers pose a serious problem for many Americans who view homeownership as a smart, safe, long-term investment, rating homeownership as a better investment than the stock market. Home equity is the single most important asset for approximately two-thirds of American households that are homeowners. Considering that half of all homeowners held at least 50 percent of their net wealth in home equity in 1998, increasing housing affordability is important for many Americans.[81]

First-time Homebuyers. First-time homebuyers are a driving force in the nation's mortgage market. The current low interest rates have made it an opportune time for first-time homebuyers, which are typically people in the 25–34 year-old age group that purchase modestly priced houses. As the post-World War II baby boom generation ages, the percentage of Americans in this age group decreased from 28.3 percent in 1980 to 25.4 percent in 1992.[82] Even though this cohort is smaller, first-time homebuyers increased their share of home sales. According to Chicago Title data for major metropolitan areas, the first-time buyer share of the homebuyer market increased from roughly 40 percent in the beginning of the 1990s to 45–47 percent during the-mid and late 1990s.[83] Since the late 1990s, industry survey data suggest that the first-time homebuyer percentage has decreased slightly. In the first quarter of 2003, the share of all home purchases by first-time homebuyers was 40 percent compared to 42 percent in 2001.[84]

In the 1990s, lenders developed special programs targeted to first-time homebuyers and revised their underwriting standards to enhance homeownership opportunities for low-income families with special circumstances. The disproportionate growth in the number of first-time homebuyers and minority homebuyers largely drove the rising trend in total home purchases. Analysis of the American Housing Survey (AHS) indicates there were 1.3 million new first-time homebuyers during 1991, in comparison with over two million in each year between 1996 and 2001. In addition, first-time homebuyers comprised approximately 60 percent of all minority home purchases during the 1990s, compared with about 35 percent of all home purchases by non-Hispanic white families.

In comparison to repeat homebuyers, first-time homebuyers are more likely to be younger, have lower incomes, and purchase less expensive houses. According to the AHS, more than one-half or first-time homebuyers were below the age of 35, compared with less than one-quarter of repeat buyers in the 1990s. Thirty-nine percent of first-time buyers had incomes below 80 percent of the median compared to 30 percent of repeat buyers. Fifty-four percent of first-time buyers purchased homes priced below $100,000, compared to 37 percent of repeat buyers. Minorities comprise a higher proportion of first-time buyers (32 percent) compared to repeat buyers (14 percent). Compared to repeat buyers, first-time homebuyers are more likely to purchase a home in the central city and more likely to be a female-headed household.[85]

The National Association of Realtors reports that the average first-time homebuyer in the first quarter of 2003 was 32 years old with a household income of $54,800, compared to an average age of 46 years and average household income of $74,600 for repeat buyers. The average first-time homebuyers made a downpayment of 6 percent on a home that cost $136,000 while the average repeat buyer made a downpayment of 23 percent on a home costing $189,000. In the NAR survey, 37 percent of first-time homebuyers were single compared to 28 percent of repeat buyers.[86]

Many African Americans and Hispanics are likely to purchase homes in the coming years, contributing to the number of first-time home-buyers fueling growth in the housing sector. The number of homeowners will rise by an average of 1.1 million annually over the next two decades. The sizeable rise in the foreign-born population since the 1970's coupled with the increase in Latin American and Asian immigration will also contribute much to this growth.[87]

d. GSEs' Acquisitions as a Share of the Primary Single-Family Mortgage Market

Purchases by the GSEs of single-family mortgages amounted to $519 billion during the heavy refinancing year of 1993, stood at $215 billion in 1995, and were at $618 billion during the heavy refinancing year of 1998. Purchases then fell to $395 billion in 2000 before reaching record levels during the heavy refinancing years of 2001 ($961 billion) and 2002 ($1,090 billion). Purchases by Fannie Mae decreased from $316 billion in 1999 to $227 billion in 2000, before rising to $568 billion in 2001 and $848 billion in 2002. Freddie Mac's single-family mortgage purchases followed a similar trend, falling

[76] Economy.com, ''The Economic Contribution of the Mortgage Refinancing Boom,'' December 2002, p. 9.

[77] Mortgage Bankers Association, ''Mortgage Finance Forecast'', March 15, 2004. *http://www.mortgagebankers.org/marketdata/forecasts/mffore1203.pdf.*

[78] Housing affordability varies markedly between regions, ranging in January 2004 from 194 in the Midwest to 107 in the West, with the South and Northeast falling in between.

[79] National Association of REALTORS. Housing Affordability Index, *http://www.realtor.org/Research.nsf/Pages/HousingInx,* 2003.

[80] Fannie Mae, September 4, 2002, p. 2.

[81] *Ibid.*

[82] U.S. Department of Commerce, Bureau of the Census, *Money Income of Households, Families, and Persons in the United States: 1992,* Special Studies Series P–60, No. 184, Table B–25, October 1993.

[83] Chicago Title and Trust Family of Insurers, *Who's Buying Homes in America,* 1998.

[84] National Association of Realtors. ''New NAR Survey of Home Buyers and Sellers Shows Growing Web Use in a Dynamic Housing Market.'' *http://www.realtor.org.*

[85] *U.S. Housing Market Conditions, 3rd Quarter 2001,* November 2001, Table 4.

[86] National Association of Realtors. ''New NAR Survey of Home Buyers and Sellers Shows Growing Web Use in a Dynamic Housing Market.'' *http://www.realtor.org.*

[87] Joint Center for Housing Studies at Harvard University, *State of the Nation's Housing 2002,* p.2.

from $233 billion in 1999 to $168 billion in 2000, and then rising to $393 billion in 2001 and $475 billion in 2002.[88]

The Office of Federal Housing Enterprise Oversight (OFHEO) estimates that the GSEs' share of total originations in the conventional single-family mortgage market, measured in dollars, declined from 37 percent in 1996 to 32 percent in 1997—well below the peak of 51 percent attained in 1993. OFHEO attributes the 1997 downturn in the GSEs' role to increased holdings of mortgages in portfolio by depository institutions and to increased competition with Fannie Mae and Freddie Mac by private label issuers. However, OFHEO estimates that the GSEs' share of the conventional market rebounded sharply in 1998–99, to 43–42 percent. The GSEs' share then decreased to approximately 30 percent of the single-family conventional mortgages originated in 2000, and then increased sharply to 40 percent in 2001. Total GSE purchases, including loans originated in prior years, amounted to 46 percent of conventional originations in 2001.[89]

e. Mortgage Market Prospects

The Mortgage Bankers Association (MBA) reports that mortgage originations in 2001 were $2.0 trillion, which is almost twice the volume of originations in 2000. Mortgage originations then increased to record levels of $2.5 trillion in 2002 and $3.8 trillion in 2003, with refinancings representing 66 percent of originations and the purchase volume amounting to $1.3 trillion. Estimates indicate that ARMs accounted for 19 percent of total mortgage originations in 2003.[90] In its March 15, 2004 forecast, MBA predicts that single-family mortgage originations will amount to $2.5 trillion in 2004 and $1.9 trillion in 2005, with refinancings representing 46 percent and 25 percent of originations respectively.

4. Affordable Lending in the Mortgage Market: New Products and Outreach

Extending homeownership opportunities to historically underserved households has been a growing concern for conventional lenders, private mortgage insurers and the GSEs. The industry has responded in what some have called a ''revolution in affordable lending.'' The industry has offered more customized mortgage products, more flexible underwriting, and expanded outreach so that the benefits of the mortgage market can be extended to those who have not been adequately served through traditional products, underwriting, and marketing.

Fannie Mae and Freddie Mac have been a part of this ''revolution in affordable lending.'' During the mid-to-late 1990s, they added flexibility to their purchase guidelines, they introduced new low-down-payment products, and they worked to expand the use of credit scores and automated underwriting in evaluating the creditworthiness of loan applicants. These major trends reflect changes in the GSEs' underwriting that have impacted affordable lending. Through these trends, Fannie Mae and Freddie Mac have attempted to increase their capacity to serve low- and moderate-income homebuyers.

This section summarizes recent initiatives undertaken by the GSEs and others in the industry to expand affordable housing. The end of this section will present evidence that these new industry initiatives are working, as increased mortgage credit has been flowing to low-income and minority families. The following section will continue the affordable lending theme by examining the performance of different market sectors (*e.g.*, depositories, GSEs, etc.) in funding loans for low-income and minority families. That section will also discuss the important role that FHA plays in making affordable housing available to historically underserved groups as well as the continuing concern that participants in the conventional market could be doing even more to help underserved families.

a. Lowering Down Payments and Up-Front Costs

Numerous studies have concluded that saving enough cash for a down payment and for up-front closing costs is the greatest barrier that low-income and minority families face when considering homeownership.[91] To assist in overcoming this barrier, the industry (including lenders, private mortgage insurers and the GSEs) began offering in 1994 mortgage products that required down payments of only 3 percent, plus points and closing costs. Other industry efforts to reduce borrowers' up-front costs included zero-point-interest-rate mortgages and monthly insurance premiums with no up front component. These new plans eliminated large up-front points and premiums normally required at closing.

During 1998, Fannie Mae introduced its ''Flexible 97'' and Freddie Mac introduced its ''Alt 97'' low down payment lending programs. Under these programs, borrowers were required to put down only 3 percent of the purchase price. The down payment, as well as closing costs, could be obtained from a variety of sources, including gifts, grants or loans from a family member, the government, a non-profit agency and loans secured by life insurance policies, retirement accounts or other assets. Fannie Mae continues to offer the ''Flexible'' line of products, and Freddie Mac continues to list ''Alt 97.''

In 2000, Fannie Mae launched the ''MyCommunityMortgage'' suite of products, which provides high loan-to-value product options for low- and moderate-income borrowers. In 2002, Fannie Mae purchased or securitized more than $882.5 million of *MyCommunityMortgage* products, which helped provide affordable housing solutions for 7,866 households. In addition, Fannie Mae created new tailored solutions to *MyCommunityMortgage* including a rural housing program, a ''Community Solutions'' program offering flexible income requirements consistent with targeted professions and an ''Energy Efficient Mortgage'' program.[92]

Fannie Mae also expanded its ''Flexible'' product line with the ''Flexible 100'' product, which eliminates the requirement for a down payment by providing 100 percent loan-to-value financing. The borrower is required to make at least a three percent contribution to closing costs; the funds for the contribution may come from a variety on sources such as gifts, grants, or unsecured loans from relatives, employers, public agencies, or nonprofits. Lenders delivered 17,206 ''Flexible 100'' loans to Fannie Mae totaling $2.2 billion in 2001.[93]

In 2001, Fannie Mae launched the *eZ Access*™ product pilot. This product is targeted to 11 underserved markets and allows lenders to qualify borrowers who may have less than perfect credit and limited available funds for down payment. Through December 2002, *eZ Access* helped 400 underserved families through Fannie Mae's purchase of $57.1 million in loans.[94]

In 2000, Freddie Mac introduced its ''Freddie Mac 100'' product, which is designed to assist borrowers who have good credit but lack the ability to provide a large down payment. ''Freddie Mac 100'' allows a 100 percent loan-to-value ratio with the condition that the borrower has the funds for closing costs. Another Freddie Mac product, ''Affordable Gold 100'' provides 100 percent financing to low- and moderate-income borrowers for the purchase price of a home in California. ''Affordable Gold 100'' combines mortgage insurance benefits provided by a state insurance fund, the secondary mortgage market, and a team of the nation's leading mortgage lenders.[95]

b. Partnerships—Fannie Mae

In addition to developing new affordable products, lenders and the GSEs have been entering into partnerships with local governments and nonprofit organizations to increase mortgage access to underserved borrowers. Fannie Mae's partnership offices in 54 central cities, which coordinate Fannie Mae's programs with local lenders and affordable housing groups, are an example of this initiative.

Fannie Mae continues to reach out to national groups and work with local affiliates

[88] The source of the GSE data for 2001 and earlier years is the Office of Federal Housing Enterprise Oversight (OFHEO), *Report to Congress*, 2002 (*see* Tables 1 and 11). The 2002 data are taken from ''Fannie and Freddie Roll to Nearly $1.5 Trillion in New Business, Portfolios Continue Growing'' in *Inside Mortgage Finance,* January 31, 2003, pages 6–7. It should be noted that the *Inside Mortgage Finance* data for 2001 was 13 percent higher than the OFHEO data for 2001; therefore, the 2002 data may be overstated.

[89] Office of Federal Housing Enterprise Oversight. ''Mortgage Markets and The Enterprises in 2001,'' August 2002, p. 13

[90] Mortgage market projections from the MBA's *MBA Mortgage Finance Forecast,* December 17, 2003. 2000 and 2001 numbers from the MBA's MBA Mortgage Finance Forecast, January 10, 2002.

[91] *See* Charles, K. K. and E. Hurst (2002). ''The Transition to Home Ownership and the Black-White Wealth Gap.'' *The Review of Economics and Statistics,* 84(2): 281–297; Mayer, C. and G. Engelhardt (1996). ''Gift Down Payments and Housing Affordability.'' *Journal of Housing Research,* 7(1): 59–77; and Quercia, R. G., G. W. McCarthy, *et al.* (2003). ''The Impacts of Affordable Lending Efforts on Homeownership Rates.'' *Journal of Housing Economics,* 12(1): 29–59.

[92] Fannie Mae, *2002 Annual Housing Activities Report,* 2003, pp. 8–9.

[93] Fannie Mae, *2001 Annual Housing Activities Report,* 2002, pp. 5–7.

[94] Fannie Mae, *2002 Annual Housing Activities Report,* 2003, p. 8.

[95] Freddie Mac, *2002 Annual Housing Activities Report,* 2003, p.57.

to expand homeownership. In 2002, Fannie Mae enhanced 5 partnerships with national organizations and maintained 13 national partnership agreements. For example, Fannie Mae maintains a partnership with the National Urban League (NUL) and the Chase Manhattan Mortgage Corporation to increase NUL's homeownership counseling capacity by providing the necessary technology and tools to support the effort, and to purchase $50 million in mortgage products over five years that are specifically targeted to African Americans and other minorities in underserved areas. In 2002, NUL originated $20 million in loans. Another example is Fannie Mae's partnership with the AFL-CIO Housing Investment Trust (HIT) and Countrywide Mortgage, which launched ''HIT HOME'' in 2001. HIT HOME is an affordable home mortgage initiative that targets 13 million union members in 16 cities throughout the nation to provide union members with a variety of affordable mortgage choices that enable them to qualify for competitively priced loans with new re-payment terms. As of December 2002, over $244 million in loans have been originated through this initiative, serving 2,076 households.[96]

In order to meet the needs of underserved and low- and moderate-income populations, Fannie Mae has targeted specific populations for initiatives. These include minority and women-owned lenders (MWOL), Native Americans, working Americans, and borrowers served by community development financial institutions and public housing agencies. In 2002, through the MWOL Initiative, Fannie Mae purchased $9 billion in mortgages originated by MWOLs; 97% of this amount reached minority households. The Employer Assisted Housing Initiative reached 116 employers in 2002 in industries ranging from health care to education. The Community Development Financial Institutions Initiative committed to invest $17.1 million in 2002, which was expected to generate more than 980 additional units of affordable housing. The Section 8 Homeownership Initiative helped 35 families make the transition from Section 8 rental housing to homeownership in 2002. The Native American Initiative has served more than 3,376 Native American families living on reservations and trust lands since its inception, while providing $290 million in mortgage financing.[97]

Fannie Mae's American Dream Commitment's Opportunity for All Strategy and National Minority Homeownership Initiative has pledged to contribute at least $700 billion in private capital to serve 4.6 million families towards President George W. Bush's goal of expanding homeownership to 5.5 million new minority Americans by the end of the decade.[98] This marks a 66% increase in Fannie Mae's earlier commitment of $420 billion. Towards this goal, in 2002, Fannie Mae announced 10 new lender partnerships, bringing the total number of lenders committed since 2000 to 16, with an estimated $180 billion of *American Dream Commitment* business pledged to be delivered. Examples of lender partnerships under this initiative include J.P. Morgan Chase & Co. with a $35 billion national investment initiative designed to increase homeownership opportunities for underserved communities and improve affordable homeownership options for immigrants and minorities, and Bank One with a $12.5 billion community lending alliance to help low- and moderate-income families purchase homes with a total designated commitment of at least 25% toward increasing homeownership among minorities.[99]

Through these partnerships, a strategic effort was made to eliminate language, credit, and other barriers to minority homeownership and to reach underserved communities. In 2002, Fannie Mae helped serve 984,276 minority families by providing $136.2 billion in mortgage financing.[100] According to Fannie Mae, its lending partners realize that multicultural markets may differ from traditional markets, and thus they offer various flexible mortgage products to reach out to minority and immigrant homebuyers. Some of these mortgage products require only a $500 contribution from the borrower for closing costs. Others have flexible qualifying guidelines that use alternative sources of income like rent and part-time employment.[101]

c. Partnerships—Freddie Mac

Freddie Mac does not have a partnership office structure similar to Fannie Mae's, but it has undertaken a number of initiatives in specific metropolitan areas.[102] In 2001, Freddie Mac joined the Congressional Black Caucus to launch a new initiative, ''With Ownership Wealth,'' designed to increase African-American homeownership with one million new families by 2005; Freddie Mac has pledged to purchase qualified mortgages originated under this initiative.[103] In 2002, Freddie Mac launched more than 30 new alliances and initiatives and continued working with existing alliances.[104] Freddie Mac has partnered with the National Council of La Raza (NCLR), 20 community based NCLR affiliated housing counseling organizations, the National Association of Hispanic Real Estate Professionals (NAHREP), EMT Applications and participating Freddie Mac Seller/Servicers including Bank of America, U.S. Bank and Wells Fargo Home Mortgage on the ''En Su Casa'' initiative. This $200 million homeownership initiative combines technology tools with flexible mortgage products to meet the needs of Hispanic borrowers. Mortgage products include low down payments, flexible credit underwriting and debt-to-income ratios, and streamlined processing for resident alien borrowers.[105]

In 2002, Freddie Mac joined with the City of Boston and the U.S. Conference of Mayors to make available the ''Don't Borrow Trouble'' predatory lending educational campaign to approximately 1,100 cities. In addition, Freddie Mac joined with Rainbow/PUSH and the National Urban League to promote the ''CreditSmart℠'' financial educational curriculum that helps consumers understand, obtain and maintain good credit, thereby preparing them for homeownership and other personal financial goals. In 2002, Freddie Mac also joined with the American Community Bankers and the Credit Union National Association in strategic alliances that will better enable member banks and credit unions access to the secondary market.[106]

In June 2002, President George W. Bush challenged the nation's housing industry to invest more than $1 trillion to make homeownership a reality for 5.5 million more minority households for the decade. Freddie Mac responded to the challenge with ''Catch the Dream,'' which is a comprehensive set of 25 major initiatives aimed at accelerating the growth in minority homeownership. The initiatives range from homebuyer education and outreach to new technologies with innovative mortgage products. Catch the Dream represents a collaborative effort with lenders, nonprofit housing and community-based organizations, and other industry participants to expand homeownership opportunities for America's minorities.[107] Freddie Mac has committed to providing $400 billion in mortgage financing for minority families by the end of the decade.[108] In 2002, Freddie Mac purchased mortgages for 576,000 minority families, a total of 17.3% of their single-family, owner-occupied mortgage purchases for the year.[109] In addition, in 2002, minority- or women-owned lenders comprised 2.7% of Freddie Mac's network of lenders. $5.5 billion in loans were purchased from these lenders, financing housing for 45,000 families.[110]

The programs mentioned above are examples of the partnership efforts undertaken by the GSEs. There are more partnership programs than can be adequately described here. Fuller descriptions of these programs are provided in their Annual Housing Activity Reports.

[96] Fannie Mae, *2002 Annual Housing Activities Report,* 2003, pp. 12–15.

[97] Fannie Mae, *2002 Annual Housing Activities Report,* 2003, pp. 16–18.

[98] Fannie Mae, *2002 Annual Housing Activities Report,* 2003, p. 15.

[99] Fannie Mae, *2002 Annual Housing Activities Report,* 2003, pp. 15–16.

[100] Fannie Mae, *2002 Annual Housing Activities Report,* 2003, p 5.

[101] Fannie Mae, ''Minority Homeownership,'' 2002.

[102] Freddie Mac, *News Release,* January 15, 1999.

[103] Freddie Mac, 2002, pp. 41–42, and Freddie Mac, *2002 Annual Housing Activities Report,* 2003, p. 62.

[104] Freddie Mac, *2002 Annual Housing Activities Report,* 2003, p. 60.

[105] Freddie Mac, *2002 Annual Housing Activities Report,* 2003, p. 61.

[106] Freddie Mac, *2002 Annual Housing Activities Report,* 2003, pp. 35–38.

[107] Freddie Mac. Corporate Information. ''Our Homeownership Commitment.'' *http://www.freddiemac.com/corporate/about/dream/expanding_minority_homeownership.htm.*

[108] Freddie Mac, *2002 Annual Housing Activities Report,* 2003, p. 28.

[109] Freddie Mac, *2002 Annual Housing Activities Report,* 2003, p. 32.

[110] Freddie Mac, *2002 Annual Housing Activities Report,* 2003, p. 15.

d. Underwriting and GSE Purchase Guidelines

Lenders, mortgage insurers, and the GSEs have also been modifying their mortgage underwriting standards to address the needs of families who have historically found it difficult to qualify under traditional guidelines. In addition to the changes in underwriting standards, the use of automated underwriting has dramatically transformed the mortgage application process. This section focuses on changes to traditional underwriting standards and recent GSE initiatives for credit-impaired borrowers. Subsequent sections will provide more details on the impact of automated underwriting.

The GSEs modified their underwriting standards to address the needs of families who find qualifying under traditional guidelines difficult. The goal of these underwriting changes is not to loosen underwriting standards, but rather to identify creditworthiness by alternative means that more appropriately measures the unique circumstances of low-income, immigrant, and minority households. Examples of changes that the GSEs and others in the industry have made to their underwriting standards include the following:

- Using a stable income standard rather than a stable job standard (or minimum period of employment). This particularly benefits low-skilled applicants who have successfully remained employed, even with frequent job changes.
- Using an applicant's history of rent and utility payments as a measure of creditworthiness. This measure benefits lower-income applicants who have not established a credit history.
- Allowing pooling of funds for qualification purposes. This change benefits applicants with extended family members. Freddie Mac, for example, allows income from relatives who live together to pool their funds to cover downpayment and closing costs and to combine their incomes for use in calculating the borrower's stable monthly income.

These underwriting changes have been accompanied by homeownership counseling to ensure homeowners are ready for the responsibilities of homeownership. In addition, the industry has engaged in intensive loss mitigation to control risks.

In 1999, HUD commissioned a study by the Urban Institute to examine the underwriting criteria that the GSEs use when purchasing mortgages from primary lenders.[111] According to the study, while the GSEs had improved their ability to serve low- and moderate-income borrowers, it did not appear at that time that they had gone as far as some primary lenders to serve these borrowers. From the Urban Institute's discussion with lenders, it was found that primary lenders were originating mortgages to lower-income borrowers using underwriting guidelines that allow lower down payments, higher debt-to-income ratios and poorer credit histories than allowed by the GSEs' guidelines.

From this and other evidence, the Urban Institute concluded that the GSEs were lagging the market in servicing low- and moderate-income and minority borrowers. Furthermore, the Urban Institute found "that the GSEs" efforts to increase underwriting flexibility and outreach has been noticed and is applauded by lenders and community advocates. Despite the GSEs' efforts in recent years to review and revise their underwriting criteria, however, they could do more to serve low- and moderate-income borrowers and to minimize disproportionate effects on minorities."[112] Since the Urban Institute study, Freddie Mac and Fannie Mae have been playing a larger role in financing low-income and minority borrowers. (*See* Section E.2.)

In addition to offering low-down-payment programs, the GSEs' recent efforts have also centered around their automated underwriting systems and their treatment of borrowers with blemished credit, the latter being perhaps the most controversial underwriting issue over the past few years. Freddie Mac recently launched a variety of new products aimed at providing borrowers with impaired credit more mortgage product choices. The new products include: "CreditWorks," which helps borrowers with excessive debt and impaired credit to qualify for a prime market rate mortgage more quickly than before, and "LeasePurchase Plus Initiative," which provides closing cost and down payment assistance in addition to extensive counseling for borrowers who have had bad credit or who have never established a credit history.[113] During 2002, Freddie Mac entered into several new markets under the "LeasePurchase Plus Initiative" and purchased more than $16 million in loans.[114]

According to Freddie Mac, its automated underwriting system, "Loan Prospector" has reduced costs, made approving mortgages easier and faster, and increased the consistency of the application of objective underwriting criteria. In addition, Freddie Mac states that "Loan Prospector" extends the benefits of the mortgage finance system to borrowers with less traditional credit profiles and limited savings by more accurately measuring risk. Freddie Mac reports that its automated underwriting system, Loan Prospector, has resulted in higher approval rates for minority borrowers than under traditional manual underwriting because of improved predictive powers. As mentioned in Section C.7, the 2000 version of LP approved 87.1 percent of loans generated through affordable housing programs, compared to 51.6 percent approved by manual underwriting. The Freddie Mac study found automated mortgage scoring less discriminatory and more accurate in predicting risk. However, as noted below in the automated mortgage scoring section, there are concerns that the codification of certain underwriting guidelines could result in unintentional discrimination or disparate treatment across groups. In response to the potential disparate impact of automated underwriting, Freddie Mac have launched initiatives to make the mortgage process more transparent by disclosing both credit and non-credit factors that Loan Prospector consider when evaluating a loan application. In 2000, Freddie Mac launched an initiative that published a list of all of the factors that Loan Prospector uses to analyze loans, and put the list on the Freddie Mac Web site.[115]

In 2002, Fannie Mae released two versions of its automated underwriting service, "Desktop Underwriter" (DU), to expand its mortgage product offerings and to update underwriting guidelines. These enhancements—labeled DU 5.2 and DU 5.2.1—increased homeownership opportunities for low- and moderate-income borrowers and borrowers with small downpayments by enhancing DU's risk assessment capabilities for certain high loan-to-value loans. For example, DU 5.2.1 enhanced its Expanded Approval™ policies to allow 100 percent loan-to-value limited cash-out refinances and the origination of 5/1 ARMs.[116] The Expanded Approval feature and Timely Payment Rewards option in DU were created by Fannie Mae in 1999 to enable lenders to more comprehensively review a borrower's creditworthiness. The Timely Payment Rewards option reduces the interest rate of qualified borrowers of up to one percent after making timely mortgage payments for a given time period.[117] With these options, lenders can offer mortgage loans to many borrowers previously unable to receive financing from a mainstream lender. A borrower who is recommended for approval for either of these features would be eligible for an initial mortgage rate that is lower than that available through the subprime market.[118] Automated mortgage scoring and the potential for disparate impacts on borrowers will be further discussed in a later section.

5. Affordable Single-Family Lending: Data Trends

a. 1993–2002 Lending Trends

HMDA data suggest that the industry and GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2002, conventional loans to low-income and minority families increased at much faster rates than loans to higher income and non-minority families. As shown below, conventional home purchase originations to African Americans more than doubled between 1993 and 2002 and those to Hispanic borrowers more than tripled. Home loans to low-income borrowers and to low-income and high-minority census tracts also more than doubled during this period.

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[111] Kenneth Temkin, Roberto Quercia, George Galster, and Sheila O' Leary, *A Study of the GSEs' Single Family Underwriting Guidelines: Final Report.* Washington DC: U.S. Department of Housing and Urban Development, April 1999.

[112] Temkin, et al. 1999, p. 28.

[113] Freddie Mac, *2001 Annual Housing Activities Report,* 2002, p. 28.

[114] Freddie Mac, *2002 Annual Housing Activities Report,* 2003, p. 35.

[115] *Ibid.* p. 57.

[116] Fannie Mae, *2002 Annual Housing Activities Report,* 2003, p. 10.

[117] *Ibid.* p. 6.

[118] Fannie Mae, *2002 Annual Housing Activities Report,* 2003, p. 32.

	1993–2002 Growth rate: all home loans P (per cent)	1993–2002 Growth rate: conventional home loans P (per cent)
African-American Borrowers	80	133
Hispanic Borrowers	186	245
White Borrowers	30	43
Low-Income Borrower (Less than 80% of AMI)	91	119
Upper-Income Borrower (More than 120% of AMI)	66	81
Low-Income Census Tract	99	143
Upper-Income Census Tract	64	78
High-Minority Tract (50% or more minority)	113	167
Predominantly-White Tract (Less than 10% minority)	53	64

GSE purchases showed similar trends, as indicated by the following 1993–to–2002 percentage point increases for metropolitan areas: African-American borrowers (193 percent), Hispanic borrowers (208 percent), and low-income borrowers (193 percent). While their annual purchases of all home loans increased by 57 percent between 1993 and 2001, their purchases of mortgages that qualify for the three housing goals increased as follows: Special affordable by 264 percent; low- and moderate-income by 142 percent; and underserved areas by 112 percent.

While low interest rates and economic expansion certainly played an important role in the substantial increase in conventional affordable lending in recent years, most observers believe that the efforts of lenders, private mortgage insurers, and the GSEs were also important contributors. In addition, many observers believe that government initiatives such as the GSE housing goals and the Community Reinvestment Act have also played a role in the growth of affordable lending over the past 10 years.

b. Affordable Lending Shares by Major Market Sector

Section E below compares the GSEs' performance with the performance of primary lenders in the conventional conforming market. To provide a useful context for that analysis, this section examines the role of the conventional conforming market in funding low-income and minority families and their neighborhoods. Information on the mortgage market's funding of homes purchased by first-time homebuyers is also provided. In addition, this section compares the GSEs with other sectors of the mortgage market. The important role of FHA in the affordable lending market is highlighted and questions are raised about whether the conventional conforming market could be doing a better job helping low-income and minority borrowers obtain access to mortgage credit.

Table A.1 reports borrower characteristics and Table A.2 reports neighborhood characteristics for home purchase mortgages insured by FHA, purchased by the GSEs, originated by depository institutions (mainly banks and thrift), and originated in the conventional conforming market and in the total market for owner-occupied properties in metropolitan areas.[119] In this case, the ''total'' market consists of both the conventional conforming market and the government (mainly FHA and VA loans) market; ''jumbo'' loans above the conventional conforming loan limit are excluded from this analysis.[120]

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[119] Table A.3 also provides the same average (1999 to 2002) information as Tables A.1 and A.2 but for total (both home purchase and refinance) loans. Thus, it provides a complete picture of overall mortgage activity.

[120] The ''Total Market'' is defined as all loans (including both government and conventional) below the conforming loan limit of $240,000 in 1999, $252,700 in 2000, $275,000 in 2001, and $300,700 in 2002.

Table A.1

Borrower Characteristics for Major Sectors of the Mortgage Market in Metropolitan Areas
Home Purchase Mortgages, 1996-2002

			Conventional Conforming Market						
						Depositories		Conforming Market	
Borrower Characteristics	Total Market	FHA	Freddie Mac	Fannie Mae	Both GSEs	Total	Portfolio	Total	W/O B&C [2]
Low-Income:									
1999	34.4 %	49.5 % [1]	25.1 %	24.7 %	24.8 %	29.2 %	28.5 %	30.1 %	29.8 %
2000	33.8	48.7	27.8	25.4	26.4	29.7	28.7	29.8	29.5
2001	33.0	50.7	26.8	27.9	27.4	28.2	29.2	28.3	28.1
2002	34.0	54.2	28.6	29.7	29.2	29.8	30.5	29.7	29.6
1999-2002 Average	33.8	50.7	27.2	27.1	27.1	29.2	29.2	29.5	29.3
1996-2002 Average	33.0	49.3	24.8	25.8	25.4	28.1	28.9	28.7	28.5
African American:									
1999	7.9	14.6	3.5	3.4	3.5	4.7	4.7	5.4	5.0
2000	8.3	15.5	4.3	4.2	4.3	5.4	5.0	5.9	5.4
2001	7.6	14.0	3.9	5.2	4.6	4.8	4.9	5.4	5.0
2002	7.5	13.9	3.5	5.4	4.7	4.9	4.8	5.8	5.3
1999-2002 Average	7.8	14.5	3.8	4.6	4.3	5.0	4.9	5.6	5.2
1996-2002 Average	7.7	14.4	3.6	4.4	4.1	4.7	4.8	5.4	5.0
Hispanic:									
1999	9.7	19.3	5.5	6.0	5.8	6.5	6.6	7.1	6.9
2000	10.9	20.7	6.6	8.0	7.4	7.9	7.7	8.3	8.1
2001	11.3	20.3	7.0	8.5	7.9	8.5	9.4	9.0	8.7
2002	12.2	20.6	6.6	10.4	9.0	9.3	9.2	10.4	9.9
1999-2002 Average	11.0	20.2	6.5	8.4	7.6	8.1	8.2	8.7	8.5
1996-2002 Average	10.1	19.2	5.9	7.6	6.9	7.0	7.0	7.7	7.5
Minority:									
1999	23.4	37.7	15.0	17.4	16.4	17.7	17.3	19.0	18.4
2000	25.4	40.2	17.6	20.2	19.0	20.4	19.6	21.2	20.5
2001	25.1	38.0	18.3	21.9	20.3	20.3	21.4	21.5	20.8
2002	26.8	38.5	18.9	24.9	22.7	22.1	21.3	24.2	23.2
1999-2002 Average	25.2	38.6	17.5	21.4	19.8	20.2	19.9	21.5	20.7
1996-2002 Average	23.5	37.3	16.0	19.8	18.3	18.2	17.7	19.6	18.9

Notes: The "1999-2002 Average" is a loan-based weighted average. All the data are for home purchase mortgages. The FHA, depositories, and market percentages are derived from HMDA data (various years). The GSE percentages are derived from the loan-level data that Fannie Mae and Freddie Mac provide to HUD. The GSE data include conventional home loans purchased during 1999, 2000, 2001 and 2002; thus, these data include their purchases of seasoned loans (i.e., mortgages originated prior to 1999 or 2000 or 2001or 2002) as well as their purchases of mortgages originated during 1999, 2000, 2001 and 2002. The "Total Market" combines the government sector (FHA and VA loans) and the conventional conforming market. Thus, it includes all loans except "jumbo" loans above the conforming loan limit which was $300,700 in 2002. "Total Depositories" data are loans originated by HMDA reporters regulated by FDIC, OTS, OCC, FRB, and The National Credit Union Administration; they consist mainly of banks, thrifts, and their subsidieries. The "Portfolio Depositories" data refer to new originations that are not sold by banks and thrift institutions during 1999-2002 and thus are retained in depository portfolios. The HMDA data for low-income borrowers exclude mortgages with a loan-to-borrower-income ratio greater than six.

[1] Each percentage represents the share of a sector's portfolio accounted for by the borrower or neighborhood characteristic based on a "distribution of business" approach or explained in the text. For example, 49.5 percent of FHA-insured home loans were loans for low-income borrowers.

[2] HMDA-based market shares that have been adjusted to exclude the B&C portion of the subprime market. It should be recognized that there exists some uncertainty regarding the number of B&C loans in the HMDA data. The adjustment assumes that the B&C loans represent one-half of the subprime market. The adjustment for home purchase loans is small because subprime (B&C) loans are mainly refinance loans.

Table A.2

Neighborhood Characteristics for Major Sectors of the Mortgage Market in Metropolitan Areas
Home Purchase Mortgages, 1996-2002

			Conventional Conforming Market						
						Depositories		Conforming Market	
Neighborhood Characteristics	Total Market	FHA	Freddie Mac	Fannie Mae	Both GSEs	Total	Portfolio	Total	W/O B&C[2]
Low-Income Tract:									
1999	12.7	18.2	8.3	7.9	8.1	10.8	11.6	11.3	10.9
2000	13.4	19.2	9.0	9.5	9.3	11.9	12.4	12.0	11.5
2001	12.5	18.2	9.4	10.1	9.8	11.0	12.3	11.0	10.7
2002	12.7	18.8	11.3	11.0	11.1	11.1	12.1	11.5	11.1
1999-2002 Average	12.8	18.6	9.6	9.8	9.7	11.2	12.1	11.4	11.1
1996-2002 Average	12.7	18.7	8.9	9.5	9.3	10.8	12.0	11.2	10.9
High-Minority Tract:									
1999	17.5	26.0	12.3	12.8	12.6	13.9	13.5	15.1	14.6
2000	18.5	26.5	12.8	15.3	14.2	15.7	14.9	16.4	15.7
2001	17.7	24.3	13.2	15.6	14.6	15.2	16.0	16.0	15.4
2002	18.6	24.0	16.2	17.3	16.9	16.1	15.5	17.5	16.7
1999-2002 Average	18.1	25.2	13.7	15.4	14.7	15.3	15.0	16.3	15.7
1996-2002 Average	17.7	25.9	12.8	15.1	14.2	14.2	13.9	15.4	14.9
High African-American Tract:									
1999	5.7	8.9	3.4	3.0	3.2	4.3	4.4	4.8	4.4
2000	6.0	9.4	3.9	3.7	3.8	5.0	4.8	5.1	4.8
2001	5.4	8.5	3.9	4.4	4.2	4.4	4.7	4.6	4.3
2002	5.5	8.4	5.3	4.7	4.9	4.6	4.8	4.9	4.6
1999-2002 Average	5.7	8.8	4.2	4.0	4.1	4.6	4.7	4.8	4.5
1996-2002 Average	5.7	9.1	3.8	4.0	3.9	4.4	4.6	4.7	4.5
Underserved Areas:									
1999	29.1	40.5	20.9	20.4	20.6	24.6	25.6	25.8	25.2
2000	30.3	42.1	22.0	23.4	22.8	26.7	27.1	27.1	26.4
2001	28.9	40.3	22.3	24.4	23.5	25.4	27.2	25.8	25.2
2002	29.7	40.9	25.8	26.7	26.3	26.2	27.2	27.2	26.4
1999-2002 Average	29.5	40.9	22.9	24.0	23.5	25.7	26.8	26.5	25.8
1996-2002 Average	29.2	41.0	21.7	23.5	22.8	24.9	26.4	25.9	25.4

See notes to Table A.1.

Table A.3

Borrower and Neighborhood Characteristics for Major Sectors of the Mortgage Market in Metropolitan Areas Home Purchase and Refinance Mortgages, 1999-2002

			Conventional Conforming Market				Conforming Market	
Borrower Characteristics	Total Market	FHA	Freddie Mac	Fannie Mae	Both GSEs	Depositories	Total	W/O B&C [2]
Low-Income:	31.6 %	50.0 % [1]	25.9 %	26.2 %	26.1 %	28.1 %	28.8 %	28.1 %
African American:	7.1	14.8	3.5	4.0	3.8	4.9	5.7	5.0
Hispanic:	9.2	19.5	5.7	7.4	6.7	7.0	7.7	7.5
Minority:	22.2	38.0	16.7	18.8	17.9	18.3	19.8	19.0
Neighborhood Characteristics								
Low-Income Tract:	12.2	17.9	9.3	9.5	9.4	10.9	11.5	10.9
High-Minority Tract:	17.6	25.5	13.9	15.3	14.7	15.1	16.6	15.7
High African-American Tract:	5.9	9.1	4.1	3.9	4.0	4.9	5.5	4.9
Underserved Areas:	28.4	40.4	23.1	23.8	23.5	25.4	26.7	25.7

Notes: The "1999-2002 Average" is a loan-based weighted average. All the data are for home purchase and refinance mortgages. The FHA, depositories, and market percentages are derived from 1999, 2000, 2001 and 2002 HMDA data (various years). The GSE percentages are derived from the loan-level data that Fannie Mae and Freddie Mac provide to HUD. The GSE data include conventional home loans purchased during 1999, 2000, 2001 and 2002; thus, these data include their purchases of seasoned loans (i.e., mortgages originated prior to 1999 or 2000 or 2001 or 2002) as well as their purchases of mortgages originated during 1999, 2000, 2001 and 2002. The "Total Market" combines the government sector (FHA and VA loans) and the conventional conforming market. Thus, it includes all loans except "jumbo" loans above the conforming loan limit which was $300,700 in 2002. "Depositories" data are loans originated by HMDA reporters regulated by FDIC, OTS, OCC, FRB, and The National Credit Union Administration; they consist mainly of banks, thrifts, and their subsidieries. The HMDA data for low-income borrowers exclude mortgages with a loan-to-borrower-income ratio greater than six.

[1] Each percentage represents the share of a sector's portfolio accounted for by the borrower or neighborhood characteristic based on "distribution of business" approach or explained in the text. For example, 50.0 percent of FHA-insured home loans between 1999 and 2002 were loans for low-income borrowers. It should be noted that due to FHA's streamline refinance program, borrower income data were not available for almost 70 percent of FHA's refinance loans.

[2] HMDA-based market shares that have been adjusted to exclude the B&C portion of the subprime market. It should be recognized that there exists some uncertainty regarding the number of B&C loans in the HMDA data. The adjustment assumes that the B&C loans represent one-half of the subprime market.

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HMDA is the source of the FHA, depository, and market data, while the GSEs provide their own data. Low-income, African-American, Hispanic, and minority borrowers are covered in Table A.1. Table A.2 provides information on four types of neighborhoods—low-income census tracts, tracts where minorities (or African Americans) account for more than 30 percent of the census tract population, and underserved areas as defined by HUD. The average data reported in Tables A.1 and A.2 for the years 1999 to 2002 offer a good summary of recent lending to low-income and minority borrowers and their communities.[121] Individual year data are also provided.

The focus of different market sectors on affordable lending is summarized by the percentages reported in Tables A.1 and A.2. These percentages show each sector's ''distribution of business,'' defined as the share of loans originated (or, for the GSEs, purchased) that had a particular borrower or neighborhood characteristic. The interpretation of the ''distribution of business'' percentages can be illustrated using the FHA percentage for low-income borrowers: Between 1999 and 2002, 50.7 of all FHA-insured home purchase loans in metropolitan areas were originated for borrowers with an income less than 80 percent of the local area median income. These percentages are to be contrasted with ''market share'' percentages, which are presented below in Section E. A ''market share'' percentage is the share of loans with a particular borrower or neighborhood characteristic that was funded by a particular market sector (*e.g.,* FHA-insured, GSEs, depositories). As will discussed below, FHA's ''market share'' for low-income borrowers during the 1999-to-2002 period was estimated to be 26 percent which is interpreted as follows: Of all home purchase loans originated for low-income borrowers in metropolitan areas between 1999 and 2002, 26 percent were FHA-insured loans. Thus, in this example, the ''distribution of business'' percentage measures the importance (or concentration) of low-income borrowers in FHA's overall business while the ''market share'' percentage measures the importance of FHA to the market's overall funding of loans for low-income borrowers. Both concepts are important for evaluating performance—for an industry sector such as FHA or the GSEs to have a significant impact on lending to a targeted group, that sector's business must be concentrated on the targeted group and that sector must be of some size. The discussion below will focus on the degree to which different mortgage sectors concentrate on targeted groups, while Section E will also provide estimates of market shares.

The main insights from the ''distribution of business'' percentages in Tables A.1 and A.2 pertain to four topics.

(i) *FHA-Insured Loans.* FHA has traditionally been the mechanism used by borrowers who face difficulty obtaining mortgage financing in the private conventional market. FHA has long been recognized as the major source of funding for first-time, low-income and minority homebuyers who are not often able to raise cash for large downpayments.[122] Tables A.1 and A.2 show that FHA places much more emphasis on affordable lending than the other market sectors. Between 1999 and 2002, low-income borrowers accounted for 50.7 percent of FHA-insured loans, compared with 27.1 percent of the home loans purchased by the GSEs, 29.2 percent of home loans originated by depositories, and 29.5 percent of all originations in the conventional conforming market (*see* Table A.1). Likewise, 40.9 percent of FHA-insured loans were originated in underserved census tracts, while only 23.5 percent of the GSE-purchased loans, 25.7 percent of home loans originated by depositories, and 26.5 percent of conventional conforming loans were originated in these tracts (*see* Table A.2).[123] As discussed in Section E, FHA's share of the minority lending market is particularly high. While FHA insured only 18 percent of all home purchase mortgages originated below the conforming loan limit in metropolitan areas between 1999 and 2002, it is estimated that FHA insured 33 percent of all home loans originated for African-American and Hispanic borrowers.

(ii) *Conventional and GSE Minority Lending.* The affordable lending shares for the conventional conforming sector are low for minority borrowers, particularly African-American and Hispanic borrowers. These borrowers accounted for only 14.3 percent of all conventional conforming loans originated between 1999 and 2002, compared with 34.7 percent of FHA-insured loans and 18.8 percent of all loans originated in the total (government and conventional conforming) market. Not surprisingly, the minority lending performance of conventional lenders has been subject to much criticism. Recent studies contend that primary lenders in the conventional market are not doing their fair share of minority lending which forces minorities, particularly African-American and Hispanic borrowers, to rely on more costly FHA and subprime loans.[124] Thus, it appears that conventional lenders could be doing a better job helping minority borrowers obtain access to mortgage credit.

- The GSEs' funding of minority loans can be compared with mortgages originated for minority borrowers in the conventional conforming market, although the latter may be a poor benchmark, as discussed above. Between 1999 and 2002, home purchase loans to African-American and Hispanic borrowers accounted for 10.3 percent of Freddie Mac's purchases, 13.0 percent of Fannie Mae's purchases, and 14.3 percent of loans originated in the conventional conforming market (or 13.7 percent if B&C loans are excluded from the market definition). Thus, since 1999, the African-American and Hispanic share of the GSEs' purchases has been lower than the corresponding share for the conventional conforming market.[125]
- As the above comparisons show, Fannie Mae has had a much better record than Freddie Mac in funding loans for minority families. And Fannie Mae significantly increased its purchases of loans for African-American and Hispanic borrowers during 2001, raising the share of its purchases to market levels—13.7 percent for both Fannie Mae and the conforming market (without B&C loans). In 2002, Fannie Mae surpassed the conventional conforming market in funding African-American and Hispanic borrowers—a 15.8 percent share for Fannie Mae and a 15.2 share for the market. When all minority borrowers are considered, Fannie Mae has purchased mortgages for

[121] The affordable market shares reported in Table A.1 for the ''Conventional Conforming Market W/O B&C'' were derived by excluding the estimated number of B&C loans from the market data reported by HMDA. Because B&C lenders operate mainly in the refinance sector, excluding these loans from the conforming market has litte impact on the home purchase percentages reported in Table A.1. The method for excluding B&C loans is explained in Section E below and Appendix D.

[122] Almost two-thirds of the borrowers with an FHA-insured home purchase loan make a downpayment less than five percent, and over 80 percent are first-time home buyers. For discussions of the role of FHA in the mortgage market, see (a) Harold L. Bunce, Charles A. Capone, Sue G. Neal, William J. Reeder, Randall M. Scheessele, and Edward J. Szymanoski, *An Analysis of FHA's Single-Family Insurance Program,* Office of Policy Development and Research, U.S. Department of Housing and Urban Development, 1995; and (b) Office of Policy Development and Research, ''FHA's Impact on Homeownership Opportunities for Low-Income and Minority Families During the 1990s' *Issue Brief IV,* U.S. Department of Housing and Urban Development, December 2000. For data on the credit characteristics of FHA borrowers, see Harold L. Bunce, William J. Reeder and Randall Scheessele, ''Understanding Consumer Credit and Mortgage Scoring: A Work in Progress at HUD'', U.S. Department of Housing and Urban Development, Unpublished Paper, 1999.

[123] FHA, which focuses on low downpayment loans and also accepts borrowers with credit blemishes, experiences higher mortgage defaults than conventional lenders and the GSEs. Still, the FHA system is actuarially sound because it charges an insurance premium that covers the higher default costs. For the results of FHA's actuarial analysis, see Deloitte & Touche, *Actuarial Review of MMI Fund as of FY 2000,* report for the U.S. Department of Housing and Urban Development, January 2001.

[124] See Green and Associates, *Fair Lending in Montgomery County: A Home Mortgage Lending Study,* a report prepared for the Montgomery County Human Relations Commission, March 1998; and Calvin Bradford, *Crisis in Déjà vu: A Profile of the Racial Patterns in Home Purchase Lending in the Baltimore Market.* Report for The Public Justice Center, May 2000; and *The Patterns of GSE Participation in Minority and Racially Changing Markets Reviewed from the Context of Levels of Distress Associated with High Levels of FHA Lending,* GSE Study No. 11, U.S. Department of Housing and Urban Development, September 2000. For analysis suggesting some minorities receiving FHA loans could qualify for conventional loans, see Anthony Pennington-Cross, Anthony Yezer, and Joseph Nichols, *Credit Risk and Mortgage Lending: Who Uses Subprime and Why?* Working Paper No. 00–03. Research Institute for Housing America, 2000. Also see the series of recent studies concerning the lack of mainstream lenders in minority neighborhoods.

[125] For a comprehensive analysis of the GSEs' purchases of minority loans through 1999, see Harold L. Bunce, *An Analysis of GSE Purchases of Mortgages for African-American Borrowers and their Neighborhoods,* Housing Finance Working Paper No. 11, Office of Policy Development and Research, HUD, December 2000.

minority borrowers at a higher rate (years 2001 and 2002) than these loans were originated by primary lenders in the conventional conforming market (without B&C loans). Freddie Mac, on the other hand, lagged behind both the market and Fannie Mae in funding loans for minority borrowers during 2001 and 2002, as well as during the entire 1999-to-2002 period. The share of Freddie Mac's purchases for African-American and Hispanic borrowers declined from 10.9 percent in both 2000 and 2001 to 10.1 percent in 2002.

• Considering the minority census tract data reported in Table A.2, Fannie Mae lagged behind the conforming market (without B&C loans) in high-minority neighborhoods and in high-African-American neighborhoods during the 1999-to-2002 period. However, Fannie Mae improved its mortgage purchases in African-American neighborhoods during 2001 and 2002 to exceed market levels by 0.1 percentage point (*e.g.*, 4.7 percent of Fannie Mae's purchases and 4.6 percent of market originations were in high African-American tracts in 2002). And during 2001 and 2002, Fannie Mae also purchased loans in high-minority census tracts at a higher rate than loans were originated by conventional lenders in these tracts. While Freddie Mac has generally lagged the primary market in funding minority neighborhoods, note in Table A.2 that high African-American tracts increased from 3.9 percent of Freddie Mac's purchases in 2001 to 5.3 percent in 2002, placing Freddie Mac above the conventional conforming market level (4.6 percent) in 2002.

(iii) *Low-Income Lending by the GSEs.* Information is also provided on the GSEs' purchases of home loans for low-income borrowers (A.1) and for families living in low-income neighborhoods (A.2). Historically, the GSEs have lagged behind the conventional conforming market in funding affordable loans for these groups. During the 1999-to-2002 period, low-income borrowers (census tracts) accounted for 27.2 (9.6) percent of Freddie Mac's purchases, 27.1 (9.8) percent of Fannie Mae's purchases, 29.2 (11.1) percent of loans originated by depositories, and 29.3 (11.1) percent of home loans originated by conventional conforming lenders (without B&C loans). By the end of this period, Fannie Mae had significantly improved its performance relative to the market. In 2002, low-income borrowers (census tracts) accounted for 29.7 (11.0) of Fannie Mae's purchases, compared with 29.6 (11.1) percent for the conforming market. It is also interesting that even though Freddie Mac lagged the market in funding home loans for low-income borrowers during 2002 (28.6 percent versus 29.6 percent), it surpassed the market in financing properties in low-income census tracts (11.3 percent versus 11.1 percent). A more complete analysis of the GSEs' recent improvements in purchasing home loans that qualify for the housing goals is provided below in Section E.

(iv) *Depositories.* Within the conventional conforming market, depository institutions (mainly banks and thrifts) are important providers of affordable lending for lower-income families and their neighborhoods.[126] Between 1999 and 2002, underserved areas accounted for 26.8 percent of loans held in depository portfolios, which compares favorably with the underserved areas percentage (26.5 percent) for the overall conventional conforming market.[127] Depository lenders have extensive knowledge of their communities and direct interactions with their borrowers, which may enable them to introduce flexibility into their underwriting standards without unduly increasing their credit risk. The Community Reinvestment Act provides an incentive for banks and thrifts to initiate affordable lending programs with underwriting flexibility and to reach out to lower income families and their communities.[128] Many of the CRA loans are held in portfolio by lenders, rather than sold to Fannie Mae or Freddie Mac.[129]

(v) *First-time Homebuyers.* As explained in Section E, market information on first-time homebuyers is not as readily available as the HMDA data reported in Tables A.1 and A.2 on the income and racial characteristics of borrowers and census tracts served by the mortgage market. However, the limited market data that are available from the American Housing Survey, combined with the first-time homebuyer data reported by FHA and the GSEs, indicate a rather large variation in the funding of first-time homebuyers across the different sectors of the mortgage market. Based on the American Housing Survey (AHS), it is estimated that first-time homebuyers accounted for 42.3 percent of all home purchase loans originated throughout the market between 1999 and 2001,[130] and for 37.6 percent of home loans originated in the conventional conforming market. The AHS defines a first-time homebuyer as someone who has never owned a home. Using a more liberal definition of a first-time homebuyer (someone who has not owned a home in the past three years), FHA reports that first-time homebuyers accounted for 80.5 percent of all home loans that it insured between 1999 and 2001 and the GSEs report that first-time homebuyers accounted for 26.5 percent of the home loans purchased by each GSE during that same period. Given FHA's low downpayment requirements, it is not surprising that FHA focuses on first-time homebuyers. The GSEs, on the other hand, fall at the other end of the continuum, with their first-time homebuyer share (26.5 percent) falling far short of the first-time homebuyer share (37.6 percent) of the conventional conforming market. Section E will include a more detailed comparison of the GSEs and the conventional conforming market in serving first-time homebuyers. In addition, Section E will conduct a market share analysis that examines the funding of minority first-time homebuyers. Consistent with the earlier discussion, that analysis suggests that conventional lenders and the GSEs have played a relatively small role in the market for minority first-time homebuyers. One analysis reported in Section E estimates that mortgage purchases by the GSEs between 1999 and 2001 totaled 41.5 percent of all home loans originated, but they accounted for only 14.3 percent of home loans originated for first-time African-American and Hispanic homebuyers.

c. Community Reinvestment Act

The Community Reinvestment Act (CRA) requires depository institutions to help meet the credit needs of their communities.[131] CRA loans are typically made to low-income borrowers earning less than 80 percent of area median income, and in moderate-income neighborhoods. CRA provides an incentive for lenders to initiate affordable lending programs with underwriting flexibility. CRA loans are usually smaller than typical conventional mortgages and also are more likely to have a higher LTV, higher debt-to-income ratios and no payment reserves, and may not be carrying private mortgage insurance (PMI). Generally, at the time CRA loans are originated, many do not meet the underwriting guidelines required in order for them to be purchased by one of the GSEs. Therefore, many of the CRA loans are held in portfolio by lenders, rather than sold to Fannie Mae or Freddie Mac. Evidence is growing that CRA-type lending to low-income families can be profitable, particularly when combined with intensive loss mitigation efforts to control credit risk. In a recent survey conducted by the Federal Reserve, lenders reported that most CRA

[126] Tables A.1, A.2, and A.3 include data for all home loans originated by depositories as well as for the subset of loans originated but not sold, the latter being a proxy for loans held in depository portfolios. (*See* the notes to Table A.1 for definitions of the depository data.)

[127] However, as shown in Table A.1 , depository institutions resemble other conventional lenders in their relatively low level of originating loans for African-American, Hispanic and minority borrowers. Within the conventional conforming market, Fannie Mae has done a better job than depositories in funding minority borrowers, particularly Hispanic borrowers and minority borrowers as a group. During the last two years, Fannie Mae has also funded African-American borrowers at a higher rate than have depository institutions.

[128] CRA loans are typically made to low-income borrowers earning less than 80 percent of area median income, and in moderate-income neighborhoods. For a comprehensive analysis of CRA and its impact on affordable lending, see Robert E. Litan, Nicolas P. Retsinas, Eric S. Belsky and Susan White Haag, *The Community Reinvestment Act After Financial Modernization: A Baseline Report*, U.S. Department of Treasury, 2000.

[129] Evidence is growing that CRA-type lending to low-income families can be profitable, particularly when combined with intensive loss mitigation efforts to control credit risk. In a survey conducted by the Federal Reserve, lenders reported that most CRA loans are profitable although not as profitable as the lenders' standard products. See Board of Governors of the Federal Reserve System. *The Performance and Profitability of CRA-Related Lending.* Washington, DC, 2000.

[130] In this case, the market includes all government and conventional loans, including jumbo loans.

[131] For a comprehensive analysis of CRA and its impact on affordable lending, see Robert E. Litan, Nicolas P. Retsinas, Eric S. Belsky and Susan White Haag, *The Community Reinvestment Act After Financial Modernization: A Baseline Report*, U.S. Department of Treasury, 2000.

loans are profitable although not as profitable as the lenders' standard products.[132]

Some anticipate that the big growth market over the next decade for CRA-type lending will be urban areas. There has been some movement of population back to cities, consisting of aging Baby Boomers (so-called ''empty nesters''), the children of Baby Boomers (the Echo Boomers aged 18–25), and immigrants, particularly Hispanics but also Asians.[133] The current low homeownership in inner cities (compared with the suburbs) also suggests that urban areas may be a potential growth market for lenders. Lenders are beginning to recognize that urban borrowers are different from suburban borrowers. A new or recent immigrant may have no credit history or, more likely, a loan-worthy credit history that can't be substantiated by the usual methods.[134] Products for duplexes and four-plexes are not the same as a mortgage for a subdivision house in the suburbs. Programs are being implemented to meet the unique needs of urban borrowers. One program emphasizing urban areas was initiated by the American Community Bankers (ACB). Under the ACB program, which made $16.2 billion in loans in 2002, lenders originated a variety of affordable products for first-time homebuyers and non-traditional borrowers that are then sold to Fannie Mae, Freddie Mac, Countrywide, or other investors that are partnering with the ACB. It is reported that some lenders are making these non-traditional loans for the first time.

For banks and thrifts, selling their CRA loans will free up capital to make new CRA loans. As a result, the CRA market segment provides an opportunity for Fannie Mae and Freddie Mac to expand their affordable lending programs. Section E.3c below presents data showing that purchasing targeted seasoned loans has been one strategy that Fannie Mae has chosen to improve its goals performance. Fannie Mae has been offering CRA programs since mid-1997, when it launched a pilot program, ''Community Reinvestment Act Portfolio Initiative,'' for purchasing seasoned CRA loans in bulk transactions, taking into account track record as opposed to relying just on underwriting guidelines. Fannie Mae also started another pilot program in 1998, involving purchases of CRA loans on a flow basis, as they are originated. By 2001, Fannie Mae was investing $10.3 billion in initiatives targeted to aid financial institutions in meeting their CRA obligations. One CRA-eligible product in 2002 included the MyCommunityMortgage suite, which provides flexible product options for low- to moderate-income borrowers purchasing one- to four-unit homes.[135] In 2002, Fannie Mae purchased or securitized more than $882.5 million of MyCommunityMortgage products, which helped provide affordable housing solutions for 7,866 households.[136] In addition, Freddie Mac is also purchasing seasoned affordable mortgage portfolios originated by depositories to help meet their CRA objectives. In 2002, Freddie Mac developed credit enhancements that enable depositories to profitably sell their loans to Freddie Mac—these transactions facilitate targeted affordable lending activity by providing immediate liquidity. Freddie Mac also increased its ability to purchase smaller portfolios opening this option to many community banks that otherwise would not have an outlet for their portfolios.[137] The billions of dollars worth of CRA loans that will be originated, as well as the CRA loans being held in bank and thrift portfolios, offer both GSEs an opportunity to improve their performance in the single-family area.

6. Potential Homebuyers

While the growth in affordable lending and homeownership has been strong in recent years, attaining this Nation's homeownership goals will not be possible without tapping into the vast pool of potential homebuyers. Due to record low interest rates, expanded homeownership outreach, and new flexible mortgage products, the homeownership rate reached an annual record of 67.9 percent in 2002, reaching 68.3 percent in the fourth quarter of 2002. This section discusses the potential for further increases beyond those resulting from current demographic trends.

The potential homeowner population over the next decade will be highly diverse, as growing housing demand from immigrants (both those who are already here and those projected to come) and non-traditional homebuyers will help to offset declines in the demand for housing caused by the aging of the population. As noted in the above discussion of CRA, many of these potential homeowners will be located in urban areas. Immigrants and other minorities—who accounted for nearly 40 percent of the growth in the nation's homeownership rate over the past five years—will be responsible for almost two-thirds of the growth in the number of new households over the next ten years (between 2000 and 2010), as well as over the next 25 years (between 2000 and 2025).[138] By 2025, non-family households will make up a third of all households. Non-Hispanic white and traditional households will contribute only one-third and one-tenth of the growth in new households, respectively. Fannie Mae staff report that between 1980 and 1995, the number of new immigrant owners increased by 1.4 million; and between 1995 and 2010, that figure is expected to rise to by more than 50 percent to 2.2 million. These trends do not depend on the future inflow of new immigrants, as immigrants don't enter the housing market until they have been in this country for eleven years. As noted by Fannie Mae staff, ''there are enough immigrants already in this country to keep housing strong for at least six and perhaps even 10 more years.'' [139] As these demographic factors play out, the overall effect on housing demand will likely be sustained growth and an increasingly diverse household population from which to draw new homeowners.

Surveys indicate that these demographic trends will be reinforced by the fact that most Americans desire, and plan, to become homeowners. According to the 2002 Fannie Mae Foundation annual National Housing Survey, Americans rate homeownership as the best investment they can make, far ahead of 401Ks, retirement accounts, and stocks. The percentage of Americans who said it was a good time to buy a home was at its highest level since 1994 at 75 percent, a jump of 21 percentage points since May 2001.[140] In addition, the survey found that 27 percent of Americans report they are likely to buy in the next three years, and 23 percent of those have started to save or have saved enough money for a down payment.[141]

Further increases in the homeownership rate depend on whether or not recent gains in the home owning share(s) of specific groups are maintained. Minorities accounted for 17 percent of owner households in 2001, but the Joint Center for Housing Studies reports that minorities were responsible for more than 40 percent (a total of 5.2 million) of the net growth in homeowners between 1993 and 2002.[142] As reported by the Fannie Mae survey, 42 percent of African-American families reported that they were ''very or fairly likely'' to buy a home in the next three years, up from 38 percent in 1998 and 25 percent in 1997. Among Hispanics and Hispanic immigrants, the numbers reached 37 percent and 34 percent respectively. The 2002 survey also reports that more than half of Hispanic renters cite homeownership as being ''one of their top priorities.'' In addition, nearly a third (31 percent) of baby boomers said they are ''very or fairly likely'' to buy a home in the next three years.

In spite of these trends, potential minority homebuyers see more obstacles to buying a home, compared with the general public. Typically, the primary barriers to ownership are credit issues and a lack of funds for a downpayment and closing costs. But Freddie Mac staff emphasize that ''immigrants and minorities face additional hurdles, including a lack of affordable housing, little understanding of the home buying process, and continuing financial obligations in their home countries.'' [143] In the Fannie Mae survey, minority groups reported misconceptions about the difficulty of becoming a homeowner such as beliefs about the amount of down payment required and mortgage lending practices, a lack of confidence about the homebuying process, poor credit ratings, and language barriers. In addition, there are continuing concerns about the limited education and low-income levels

[132] Board of Governors of the Federal Reserve System. *The Performance and Profitability of CRA-Related Lending.* Washington, DC, 2000.

[133] This discussion of urban lending draws from Jeff Siegel, ''Urban Lending Helps Increase Volume and Meet CRA Requirements,'' *Secondary Marketing Executive,* February 2003, pp. 21–23.

[134] *Ibid.*

[135] Fannie Mae, (2002), p. 5.

[136] Fannie Mae, *2002 Annual Housing Activities Report,* p. 9.

[137] Fannie Mae, *2002 Annual Housing Activities Report,* p. 59.

[138] This section draws from ''Immigration Changes Won't Hurt Housing,'' *Nation Mortgage News,* January 27, 2003, p. 8.

[139] *Ibid.*

[140] Fannie Mae, *Fannie Mae National Housing Survey,* 2002, p. 6.

[141] *Ibid.* p. 8.

[142] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2003,* p. 15.

[143] ''Immigration Changes. * * *'' *Op. cit.*

of recent immigrants and other minorities. Thus, the new group of potential homeowners will have unique needs. To tap this potential homeowner population, the mortgage industry will have to address these needs on several fronts, such as expanding education and outreach efforts, introducing new products, and adjusting current underwriting standards to better reflect the special circumstances of these new households.

The Bush administration has outlined a plan to expand minority homeownership by 5.5 million families by the end of the decade. The Joint Center for Housing Studies has stated that if favorable economic and housing market trends continue, and if additional efforts to target mortgage lending to low-income and minority households are made, the overall homeownership rate could reach 70 percent by 2010.[144]

7. Automated Underwriting Systems and Mortgage Scorecards

This, and the following two sections, discuss special topics that have impacted the primary and secondary mortgage markets in recent years. They are automated mortgage scoring, subprime loans, and risk-based pricing. The GSEs' use of automated underwriting and mortgage scoring systems was briefly discussed in the earlier section on underwriting standards. This section expands on issues related to automated underwriting, a process that has spread throughout the mortgage landscape over the past five years, due mainly to the efforts of Fannie Mae and Freddie Mac.

According to Freddie Mac economists, automated mortgage scoring has enabled lenders to expand homeownership opportunities, particularly for underserved populations.[145] There is growing evidence that automated mortgage scoring is more accurate than manual underwriting in predicting borrower risks. Mortgage scorecards express the probability that an applicant will default as a function of several underwriting variables such as the level of down payment, monthly-payment-to-income ratios, cash reserves, and various indicators of an applicant's creditworthiness or credit history. Mortgage scorecards are statistically estimated regression-type equations, based on historical relationships between mortgage foreclosures (or defaults) and the underwriting variables. The level of down payment and credit history indicators, such as a FICO score, are typically the most important predictors of default in mortgage scoring systems.

This increased accuracy in risk assessment of mortgage scorecards has allowed risk managers to set more lenient risk standards, and thus originate more loans to marginal applicants. Applicants who would otherwise be rejected by manual underwriting are being qualified for mortgages with automated mortgage scoring in part because the scorecard allows an applicant's weaker areas to be offset by stronger characteristics. Typically, applicants whose projected monthly debt payment (mortgage payment plus credit card payment plus automobile loan payment and so on) comprise a high percentage of their monthly income would be turned down by a traditional underwriting system that relied on fixed debt-to-income ratios (such as 36 percent). In a mortgage scoring system, these same applicants might be automatically accepted for a loan due to their stellar credit record or to their ability to raise more cash for a down payment. The entity funding or insuring the mortgage (*i.e.*, a lender, private mortgage insurer, or a GSE) allows these positive characteristics to offset the negative characteristics because its confidence in the ability of the empirically-based mortgage scorecard to accurately identify those applicants who are more likely or less likely to eventually default on their loan.

Automated mortgage scoring was developed as a high-tech tool with the purpose of identifying credit risks in a more efficient manner. Automated mortgage scoring has grown as competition and decreased profit margins have created demands to reduce loan origination costs. As a result, automated mortgage scoring has become the predominant (around 60 to 70 percent) mortgage underwriting method.[146] As time and cost are reduced by the automated system, the hope was that more time would be devoted by underwriters to qualifying marginal loan applicants that are referred by the automated system for a more intensive, manual underwriting review. Fannie Mae and Freddie Mac are in the forefront of new developments in automated mortgage scoring technology. Both enterprises released automated underwriting systems in 1995—Freddie Mac's Loan Prospector and Fannie Mae's Desktop Underwriter. Each system uses numerical credit scores, such as those developed by Fair, Isaac, and Company, and additional data submitted by the borrower, such as loan-to-value ratios and available assets, to calculate a mortgage score that evaluates the likelihood of a borrower defaulting on the loan. The mortgage score is in essence a recommendation to the lender to accept the application, or to refer it for further review through manual underwriting. Accepted loans benefit from reduced document requirements and expedited processing.

As explained above, automated mortgage scoring allows tradeoffs between risk factors to be quantified more precisely, providing the industry more confidence in ''pushing the envelope'' of acceptable expected default rates. The GSEs' willingness to offer low-down-payment programs was based on their belief that their scoring models could identify the more creditworthy of the cash-constrained applicants. The GSEs' new ''timely reward'' products for subprime borrowers (discussed later) are integrated with their mortgage scoring systems. Automated mortgage scoring presents the opportunity to remove discrimination from mortgage underwriting, to accept all applicants, and to bring fair, objective, statistically based competitive pricing, greatly reducing costs for all risk groups. Some institutions have sought to better model and automate marginal and higher-risk loans, which have tended to be more costly to underwrite and more difficult to automate.[147]

Along with the promise of benefits, however, automated mortgage scoring has raised concerns. These concerns are related to the possibility of disparate impact and the proprietary nature of the mortgage score inputs. The first concern is that low-income and minority homebuyers will not score well enough to be accepted by the automated underwriting system, resulting in their getting fewer loans. African-American and Hispanic borrowers, for example, tend to have a poorer credit history record than other borrowers, which means they are more likely to be referred (rather than automatically accepted) by automated mortgage scoring systems that rely heavily on credit history measures such as a FICO score. There is also a significant statistical relationship between credit history scores and the minority composition of an area, after controlling for other locational characteristics.[148]

The second concern relates to the ''black box'' nature of the scoring algorithm. The scoring algorithm is proprietary and therefore it is difficult for applicants to know the reasons for their scores. However, it should be noted that the GSEs have taken steps to make their automated underwriting systems more transparent. Both Fannie Mae and Freddie Mac have published the factors used to make loan purchase decisions in Desktop Underwriter and Loan Prospector, respectively. In response to criticisms aimed at using FICO scores in mortgage underwriting, Fannie Mae's new version of Desktop Underwriter (DU) 5.0 replaces credit scores with specific credit characteristics and provides expanded approval product offerings for borrowers who have blemished credit. The specific credit characteristics include variables such as past delinquencies; credit records, foreclosures, and accounts in collection; credit card line and use; age of accounts; and number of credit inquiries.[149]

With automated mortgage scoring replacing traditional manual underwriting comes the fear that the loss of individual attention poses a problem for people who have inaccuracies on their credit report or for members of cultural groups or recent immigrants who do not use traditional credit and do not have a credit score. Some subprime lenders and underwriters have claimed that their manual underwriting of

[144] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 1998,* p. 20.

[145] Peter M. Zorn, Susan Gates, and Vanessa Perry, ''Automated Underwriting and Lending Outcomes: The Effect of Improved Mortgage Risk Assessment on Under-Served Populations. Program on Housing and Urban Policy,'' *Conference Paper Series,* Fisher Center for Real Estate and Urban Economics. University of California Berkeley, 2001, p. 5.

[146] John W. Straka, ''A Shift in the Mortgage Landscape: The 1990s Move to Automated Credit Evaluations,'' *Journal of Housing Research,* 2000, (11)2: p. 207.

[147] *Ibid.* pp. 208–217.

[148] Robert B. Avery, Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner, *Credit Scoring: Issues and Evidence from Credit Bureau Files,* mimeo, 1998, p. 24.

[149] Fannie Mae, September 4, 2002, p. 33.

high-risk borrowers cannot be automated with mortgage scoring. Although automated mortgage scoring has greatly reduced the cost of many lower-risk loans that are easier to rate, the cost of manually underwriting gray-area and higher-risk applicants still remains high.[150] There is also the fear that applicants who are referred by the automated system will not be given the full manual underwriting for the product that they initially applied for—rather they might be pushed off to higher priced products such as a subprime or FHA loan. In this case, the applicant may have had special circumstances that would have been clarified by the traditional manual underwriting, thus enabling the applicant to receive a prime loan consistent with his or her creditworthiness.

Banking regulators and legal analysts acknowledge the value of automated mortgage scoring, although some skeptics have noted concerns regarding fair lending, potential fraud, privacy issues, and the ability of models to withstand changing economic conditions.[151] With the rise of automated mortgage scoring, the great difference in Internet usage known as the ''digital divide'' could result in informational disadvantages for less educated and lower-income consumers. In addition to the digital divide, the lack of financial literacy in the United States may also result in a disparate impact on low-income and minority borrowers.[152]

2002 Urban Institute Study. The Urban Institute submitted a report to HUD in 2002 on subprime markets, the role of GSEs, and risk-based pricing.[153] The study took a preliminary look at the use of automated underwriting systems for a small sample of lenders. After conducting interviews with both subprime and prime lenders, the report noted that all of the lenders in the study had implemented some type of automated underwriting system. These lenders stated that automated underwriting raised their business volume and streamlined their approval process. In addition, the lenders reported they were able to direct more underwriting resources to borderline applications despite an increase in business volume.

Even with the use of automated mortgage scoring, the lenders in the study continued to conduct at least a cursory review to validate the application material. The majority of the lenders still used manual underwriting to originate loans not recommended for approval with automated mortgage scoring. The lenders reported they formulated their policies and procedures to make certain that borrowers receive the best mortgage, according to product eligibility. This study will be further referenced in a following section regarding subprime markets.

2001 Freddie Mac Study. According to a Freddie Mac study published by the Fisher Center for Real Estate and Urban Economics at University of California at Berkeley, underserved populations have benefited from automated mortgage scoring because of the increased ability to distinguish between a range of credit risks. In this paper, Freddie Mac economists compared the manual and automated mortgage scoring approval rates of a sample of minority loans originated in 1993–94 and purchased by Freddie Mac. While manual underwriters rated 51 percent of the minority loans in the sample as accept, automated mortgage scoring would have rated 79 percent of the loans as accept.[154]

In comparison to manual underwriting, this study found automated mortgage scoring not only less discriminatory but also more accurate in predicting risk. Two versions of Freddie Mac's automated underwriting system, Loan Prospector (LP), were used to review three groups of mortgage loans purchased by Freddie Mac.[155] The study found that LP was a highly accurate predictor of mortgage default. The resulting improved accuracy translates into benefits for borrowers, who would otherwise be rejected by manual underwriting to qualify for mortgages.

Analysis of the first group of loans showed that loans rated as ''caution'' were four times more likely to default than the average for all loans. Minority borrowers whose loans were rated as ''caution'' were five times more likely to default, and low-income borrowers whose loans were rated as ''caution'' were four times more likely to default than the average for all loans. The 2000 version of LP approved 87.1 percent of loans generated through affordable housing programs, compared to a 51.6 percent approval rate when the same loans were assessed using manual underwriting procedures. Further, the study found LP more accurate than manual underwriting at predicting default risk even with a higher approval rate. The study also demonstrated that Freddie Mac's year 2000 version of LP was more accurate in predicting risk than its 1995 version.

Concluding Observations. Automated underwriting has enabled lenders to reach new markets and expand homeownership opportunities, as illustrated by the 2001 Freddie Mac study. Increased accuracy with automated mortgage scoring has led to the development of new mortgage products that would have been previously considered too risky. For example, Freddie Mac uses Loan Prospector to approve Alt A loans, which tend to have nontraditional documentation; A-minus loans, which pose a higher risk of default; and other higher-risk mortgages, like 100 percent LTV loans. Both GSEs have and continue to add new products to develop their automated underwriting systems to reach more marginal borrowers.

Despite the gains in automated mortgage scoring and other innovations, minorities are still less likely to be approved for a loan. The difference in minority and non-minority accept rates may reflect greater social inequities in financial capacity and credit, which are integral variables in both manual and automated underwriting. In the future, the accuracy of automated mortgage scoring will hinge on updating the models and making them more predictive while reducing the disparate impact on low-income and minority borrowers.[156] The fairness of automated scoring systems will also depend importantly on whether referred applicants receive a traditional manual underwriting for the loan that they initially applied for, rather than being immediately offered a higher priced loan that does not recognize their true creditworthiness.

In addition to using automated underwriting systems as a tool to help determine whether a mortgage application should be approved, the GSEs' automated underwriting systems are being further adapted to facilitate risk-based pricing. With risk-based pricing, mortgage lenders can offer each borrower an individual rate based on his or her risk. The division between the subprime and the prime mortgage market will begin to fade with the rise of risk-based pricing, which is discussed in the next section on the subprime market.

8. Subprime Lending

The subprime mortgage market provides mortgage financing to credit-impaired borrowers—those who may have blemishes in their credit record, insufficient credit history, or non-traditional credit sources. This section examines several topics related to subprime lending including (a) the growth and characteristics of subprime loans, (b) the neighborhood concentration of subprime lending, (c) predatory lending, and (d) purchases of subprime mortgages by the GSEs. Section C.9 follows with a discussion of risk-based pricing.

a. The Growth and Characteristics of Subprime Loans

The subprime market has grown rapidly over the past several years, increasing from an estimated $35 billion in 1994 to $160 billion in 1999 and $173.3 billion in 2001, before rising to $213 billion in 2002. The subprime share of total market originations rose from 4.6 percent in 1994 to a high of 15 percent in 1999, and then fell to 8.5 percent in both 2001 and 2002.[157] Various factors have led to the rapid growth in the subprime market: federal legislation preempting state restrictions on allowable rates and loan features, the tax reform act of 1986 which encouraged tax-exempt home equity financing of consumer debt, increased demand for and availability of consumer debt, a substantial increase in homeowner equity due to house price appreciation, and a ready supply of available funds through

[150] Kenneth Temkin, Jennifer E.H. Johnson, and Diane Levy, *Subprime Markets, The Role of GSEs, and Risk-Based Pricing,* Washington: The Urban Institute. Report Prepared for the U.S. Department of Housing and Urban Development, 2002.

[151] Allen J. Fishbein, ''Is Credit Scoring a Winner for Everyone?'' *Stone Soup,* 2000, 14(3): pp. 14–15. See also Fitch IBCA, Inc., *Residential Mortgage Credit Scoring,* New York, 1995 and Jim Kunkel, ''The Risk of Mortgage Automation,'' in *Mortgage Banking,* 1995, 57(8): pp. 69–76.

[152] Zorn *et al.*, 2001, pp. 19–20.

[153] Kenneth Temkin, Jennifer E.H. Johnson, and Diane Levy, *Subprime Markets, The Role of GSEs, and Risk-Based Pricing,* Washington: The Urban Institute. Report Prepared for the U.S. Department of Housing and Urban Development, 2002.

[154] Zorn, *et al.*, 2001, pp. 14–15.

[155] *Ibid.* p. 5.

[156] *Ibid.* pp. 18–19.

[157] Subprime origination data are from Inside Mortgage Finance. For the 2002 estimates, see ''Subprime Origination Market Shows Strong Growth in 2002,'' *Inside B&C Lending,* published by Inside Mortgage Finance, February 3, 2003, page 1.

Wall Street securitization.[158] It is important to note that subprime lending grew in the 1990s mostly without the assistance of Fannie Mae and Freddie Mac.

Generally, there are three different types of products available for subprime borrowers. These include: home purchase and refinance mortgages designed for borrowers with poor credit histories; ''Alt A'' mortgages that are usually originated for borrowers who are unable to document all of the underwriting information but who may have solid credit records; and high loan-to-value mortgages originated to borrowers with fairly good credit. Fannie Mae and Freddie Mac are more likely to serve the first two types of subprime borrowers.[159]

Borrowers use subprime loans for various purposes, which include debt consolidation, home improvements, and an alternative source of consumer credit. Between 1999 and 2001, about two-thirds of subprime loans were refinance loans. It has been estimated that 59 percent of refinance loans were ''cash out'' loans.[160] According to a joint HUD-Treasury report, first liens accounted for more than three out of four loans in the subprime market.

The subprime market is divided into different risk categories, ranging from least risky to most risky: A-minus, B, C, and D. While there are no clear industry standards for defining the subprime risk categories, Inside Mortgage Finance defines them in terms of FICO scores—580–620 for A-minus, 560–580 for B, 540–560 for C, and less than 540 for D. The A-minus share of the subprime market rose from 61.6 percent in 2000 to 70.7 percent in 2001.[161] For the first nine months of 2002, the A-minus share accounted for 74 percent of the market, while the B share accounted for 11 percent, the C share accounted for 7.2 percent, and the D share accounted for 7.9 percent of the market.[162]

Delinquency rates by type of subprime loan are as follows: 3.36 percent for A-minus loans, 6.67 percent for B, 9.22 percent for C, and 21.03 percent for D, according to the Mortgage Information Corporation.[163] Because of their higher risk of default, subprime loans typically carry much higher mortgage rates than prime mortgages. Recent quotes for a 30-year Fixed Rate Mortgage were 8.85 percent for A-minus (with an 85 percent LTV), 9.10 percent for B credit (with an 80 percent LTV), and 10.35 percent for C credit (with a 75 percent LTV).[164] As the low loan-to-value (LTV) ratios indicate, one loss mitigation technique used by subprime lenders is a high down payment requirement. Some housing advocates have expressed concern that the perceptions about the risk of subprime loans may not always be accurate, for example, creditworthy borrowers in inner city neighborhoods may be forced to use subprime lenders because mainstream lenders are not doing business in their neighborhoods (see below).

Subprime borrowers are much more likely to be low income and be a minority than other borrowers. Between 1999 and 2001, 43.1 percent of subprime loans in the conventional conforming market went to low-income borrowers, compared with 29.5 percent of conventional conforming loans. During that same period, 19.9 percent of subprime loans were for African-American borrowers, compared with 6.5 percent of all conventional conforming loans. However, what distinguishes subprime loans from other loans is their concentration in African-American neighborhoods.

b. The Neighborhood Concentration of Subprime Lending

The growth in subprime lending over the last several years has benefited credit-impaired borrowers as well as those borrowers who choose to provide little documentation for underwriting. However, studies showing that subprime lending is disproportionately concentrated in low-income and minority neighborhoods have raised concerns about whether mainstream lenders are adequately serving these neighborhoods. A study of subprime lending in Chicago by The Woodstock Institute concluded that a dual, hyper-segmented mortgage market existed in Chicago, as mainstream lenders active in white and upper-income neighborhoods were much less active in low-income and minority neighborhoods—effectively leaving these neighborhoods to unregulated subprime lenders.[165] As part of the HUD-Treasury Task Force on Predatory Lending, HUD's Office of Policy Development and Research released a national level study—titled *Unequal Burden: Income and Racial Disparities in Subprime Lending in America*—that showed families living in low-income and African-American neighborhoods in 1998 relied disproportionately on subprime refinance lending, even after controlling for neighborhood income. An update of that analysis for the year 2000 yields the following trends: [166]

- In 2000, 36 percent of refinance mortgages in low-income neighborhoods were subprime, compared with only 16 percent in upper-income neighborhoods.
- Subprime lending accounted for 50 percent of refinance loans in majority African-American neighborhoods—compared with only 21 percent in predominantly white areas (less than 30 percent of population is African-American).
- The most dramatic view of the disparity in subprime lending comes from comparing homeowners in upper-income African-American and white neighborhoods. Among homeowners living in the upper-income white neighborhoods, only 16 percent turned to subprime lenders in 2000. But 42 percent of homeowners living in upper-income African-American neighborhoods relied upon subprime refinancing which is substantially more than the rate (30 percent) for homeowners living in low-income white neighborhoods.
- Similar results are obtained when the analysis is conducted for borrowers instead of neighborhoods. Upper-income African-American borrowers are twice as likely as low-income white borrowers to have subprime loans. Over one-half (54 percent) of low-income African-American borrowers turn to subprime lenders, as does over one-third (35 percent) of upper-income African-American borrowers. By comparison, only 24 percent of low-income white borrowers and 12 percent of upper-income white borrowers, rely upon subprime lenders for their refinance loans.[167]

It does not seem likely that these high market shares by subprime lenders in low-income and African-American neighborhoods can be justified by a heavier concentration of households with poor credit in these neighborhoods. Rather it appears that subprime lenders may have attained such high market shares by serving areas where prime lenders do not have a significant presence. The above finding that upper-income black borrowers rely more heavily on the subprime market than low-income white borrowers suggests that a portion of subprime lending is occurring with borrowers whose credit would qualify them for lower cost conventional prime loans. A lack of competition from prime lenders in low-income and minority neighborhoods has increased the chances that borrowers in these communities are paying a high cost for credit. As explained

[158] Temkin et. al, 2002, p.1.

[159] Kenneth Temkin, Jennifer E.H. Johnson, Diane Levy, *Subprime Markets, The Role of GSEs, and Risk Based Pricing*, Washington: The Urban Institute. Report Prepared for the Department of Housing and Urban Development, 2002, p. 4.

[160] U.S. Department of Housing and Urban Development/U.S. Department of the Treasury, *Curbing Predatory Lending Report,* 2000, p. 31.

[161] ''Wholesale Dominates Subprime Market Through 3rd Quarter '02,'' *Inside B&C Lending,* published by Inside Mortgage Finance, December 16, 2002, pp. 1–2.

[162] *Inside B&C Lending,* November 16, 2002, p. 2.

[163] Mortgage Information Corporation, *The Market Pulse,* Winter 2001, pp. 4–6.

[164] *Inside B&C Lending,* published by Inside Mortgage Finance, February 17, 2003, page 13.

[165] Daniel Immergluck, *The Predatory Lending Crisis in Chicago: The Dual Mortgage Market and Local Policy*, testimony before the Chicago City Council, April 5, 2000. Immergluck found that subprime lenders received 74 percent of refinance applications in predominantly black tracts compared to 21 percent in predominantly white tracts in 1998. According to Immergluck, these racial disparities provide evidence that the residential finance market in Chicago is hypersegmented, resulting in the increased likelihood that minorities receive mortgage credit from a subprime, rather than a prime, lender in Chicago. Also see Daniel Immergluck, *Stark Differences: The Explosion of the Subprime Industry and Racial Hypersegmentation in Home Equity Lending,* Woodstock Institute, October 2000.

[166] See Randall M. Scheessele, *Black and White Disparities in Subprime Mortgage Refinance Lending,* Housing Finance Working Paper HF–014, Office of Policy Development and Research, U.S. Department of Housing and Urban Development, April 2002.

[167] For an update to 2001, see The Association of Community Organizers for Reform Now (ACORN), *Separate and Unequal Predatory Lending in America*, 2002. In 2001, subprime lenders originated 27.8 percent of all conventional refinance loans for African-Americans, 13.6 percent for Hispanic homeowners, and just 6.3 percent for white homeowners. Overall, African-Americans were 4.4 times more likely to use a subprime lender than whites, and Hispanics were 2.2 times more likely to do so.

next, there is also evidence that the higher interest rates charged by subprime lenders cannot be fully explained solely as a function of the additional risks they bear. Thus, a greater presence by mainstream lenders could possibly reduce the high up-front fees and interest rates being paid by residents of low-income and minority neighborhoods.

The Freddie Mac study presented evidence that subprime loans bear interest rates that are higher than necessary to offset the higher credit risks of these loans.[168] The study compared (a) the interest rate on subprime loans rated A-minus by the lenders originating these loans with (b) the interest rates on prime loans purchased by Freddie Mac and rated A-minus by a Freddie Mac underwriting model. Despite the fact that both loan groups were rated A-minus, on average the subprime loans bore interest rates that were 215 basis points higher. Even assuming that the credit risk of the subprime loans was in fact higher than the prime loans, the study could not account for such a large discrepancy in interest rates. Assuming that default rates might be three to four times higher for the subprime loans would account for a 90 basis point interest rate differential. Assuming that servicing the subprime loans would be more costly would justify an additional 25 basis point differential. But even after allowing for these possible differences, the Freddie Mac researchers concluded that the subprime loans had an unexplained interest rate premium of 100 basis points on average.[169]

Banking regulators have recognized the link between the growth in subprime lending and the absence of mainstream lenders and have urged banks and thrifts that lending in these neighborhoods not only demonstrates responsible corporate citizenship but also profitable lending. Ellen Seidman, former Director of the Office of Thrift Supervision, stated that, ''Many of those served by the subprime market are creditworthy borrowers who are simply stuck with subprime loans or subprime lenders because they live in neighborhoods that have too few credit or banking opportunities.''

With respect to the question of whether borrowers in the subprime market are sufficiently creditworthy to qualify for more traditional loans, Freddie Mac has said that one of the promises of automated underwriting is that it might be better able to identify borrowers who are unnecessarily assigned to the high-cost subprime market. Freddie Mac has estimated that 10–30 percent of borrowers who obtain mortgages in the subprime market could qualify for a conventional prime loan through Loan Prospector, Freddie Mac's automated underwriting system.[170] Fannie Mae has stated that half of all mortgage borrowers steered to the high-cost subprime market are in the A-minus category, and therefore are prime candidates for Fannie Mae.[171]

c. Predatory Lending

Predatory lending has been a disturbing part of the growth in the subprime market. Although questions remain about its magnitude, predatory lending has turned homeownership into a nightmare for far too many households. The growing incidence of abusive practices has been stripping borrowers of their home equity, threatening families with foreclosure, and destabilizing neighborhoods. Also, in some cities, there are indications that unscrupulous realtors, mortgage brokers, appraisers, and lenders are duping some FHA borrowers into purchasing homes at an inflated price or with significant undisclosed repairs. The problems associated with home equity fraud and other mortgage abuses are not new ones, but the extent of this activity seems to be increasing. The expansion of predatory lending practices along with subprime lending is especially troubling since subprime lending is disproportionately concentrated in low- and very-low income neighborhoods, and in African-American neighborhoods.

The term ''predatory lending'' is a short hand term that is used to encompass a wide range of abuses. While there is broad public agreement that predatory lending should have no place in the mortgage market, there are differing views about the magnitude of the problem, or even how to define practices that make a loan predatory. The joint HUD-Treasury report, *Curbing Predatory Home Mortgage Lending*, concluded that a loan can be predatory when lenders or brokers: charge borrowers excessive, often hidden fees (called ''packing fees''); successively refinance loans at no benefit to the borrower (called ''loan flipping''); make loans without regard to a borrower's ability to repay; and, engage in high-pressure sales tactics or outright fraud and deception. These practices are often combined with loan terms that, alone or in combination, are abusive or make the borrower more vulnerable to abusive practices. Vulnerable populations, including the elderly and low-income individuals, and low-income or minority neighborhoods, appeared to be especially targeted by unscrupulous lenders.

One consequence of predatory lending is that borrowers are stripped of the equity in their homes, which places them at an increased risk of foreclosure. In fact, high foreclosure rates for subprime loans provide the most concrete evidence that many subprime borrowers are entering into mortgage loans that they simply cannot afford. The high rate of foreclosures in the subprime market has been documented by HUD and others in recent research studies.[172] These studies have found that foreclosures by subprime lenders grew rapidly during the 1990s and now exceed the subprime lenders' share of originations. In addition, the studies indicate that foreclosures of subprime loans occur much more quickly than foreclosures on prime loans, and that they are concentrated in low-income and African-American neighborhoods. Of course, given the riskier nature of these loans, a higher foreclosure rate would be expected. With the information available it is not possible to evaluate whether the disparities in foreclosure rates are within the range of what would be expected for loans prudently originated within this risk class. But findings from these studies about the high rate of mortgage foreclosure associated with subprime lending reinforce the concern that predatory lending can potentially have devastating effects for individual families and their neighborhoods.

At this time, there are open questions about the effectiveness of the different approaches being proposed for eradicating predatory lending and the appropriate roles of different governmental agencies—more legislation versus increased enforcement of existing laws, long-run financial education versus mortgage counseling, Federal versus state and local actions. In its recent issuance of predatory lending standards for national banks, the Office of the Comptroller of the Currency (OCC) cited the efforts of Fannie Mae and Freddie Mac' in reducing predatory lending.[173] The OCC advised banks against abusive practices, such as rolling single-premium life insurance into a loan. The agency cited guidelines developed by Fannie Mae and Freddie Mac as a ''useful reference'' or starting point for national banks. Following publication of HUD's proposed 2000 Rule inviting comments on disallowing goals credit for high cost mortgage loans, Fannie Mae and Freddie Mac told lenders they would no longer purchase loans with certain abusive practices, such as excessive fees and failing to consider a borrower's ability to repay the debt.

It is important to re-emphasize that predatory lending generally occurs in neighborhoods where borrowers have limited access to mainstream lenders. While predatory lending can occur in the prime market, it is ordinarily deterred in that market by competition among lenders, greater homogeneity in loan terms and greater financial information among

[168] Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, ''Subprime Lending: An Investigation of Economic Efficiency,'' February 25, 2000.

[169] It should also be noted that higher interest rates are only one component of the higher cost of subprime loans since borrowers also often face higher origination points. The Freddie Mac study did not find a large differential between prime and subprime loans in points paid, but the study notes that subprime loans often have points rolled into the loan principal, which cannot be identified with their data.

[170] Freddie Mac, *We Open Doors for America's Families*, Freddie Mac's Annual Housing Activities Report for 1997, March 16, 1998, p. 23.

[171] Rommy Fernandez, ''Fannie Mae Eyes Half of the Subprime Market,'' in *The American Banker*, March 1, 2002. Also see ''Fannie Mae Vows More Minority Lending,'' *Washington Post*, March 16, 2000, p. EO1.

[172] For an overview of these studies, see Harold L. Bunce, Debbie Gruenstein, Christopher E. Herbert, Randall M. Scheessele, *Subprime Foreclosures: The Smoking Gun of Predatory Lending*, 2000. Also see Abt Associates Inc., *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Atlanta Metro Area*, February 2000 and *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Boston Metro Area*, September 2000; National Training and Information Center, *Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosures*, 2000; and the HUD study, *Unequal Burden in Baltimore: Income and Racial Disparities in Subprime Lending*, May 2000.

[173] ''OCC Cites Fannie, Freddie Predatory Lending Rules As Model,'' Dow Jones Business News, February 25, 2003.

borrowers. Thus, one solution to address this problem would be to encourage more mainstream lenders to do business in our inner city neighborhoods.

d. Purchases of Subprime Mortgages by the GSEs

Fannie Mae and Freddie Mac have shown increasing interest in the subprime market since the latter half of the 1990s. The GSEs entered this market by purchasing securities backed by non-conforming loans. Freddie Mac, in particular, increased its subprime business through structured transactions, with Freddie Mac guaranteeing the senior classes of senior/subordinated securities. The two GSEs also purchase subprime loans on a flow basis. Fannie Mae began purchasing subprime loans through its Timely Payment Reward Mortgage program in June 1999, and Freddie Mac rolled out a similar product, Affordable Merit Rate, in May 2000 (described below). In addition to purchasing subprime loans for borrowers with blemished credit, the GSEs also purchase another non-conforming loan called an Alternative-A or ''Alt-A'' mortgage. These mortgages are made to prime borrowers who do not want to provide full documentation for loans. The GSEs' interest in the subprime market has coincided with a maturation of their traditional market (the conforming conventional mortgage market), and their development of mortgage scoring systems, which they believe allows them to accurately model credit risk. Although the GSEs account for only a modest share of the subprime market today, some market analysts estimate that they could purchase as much as half of the overall subprime market in the next few years.[174]

Precise information on the GSEs' purchases of subprime loans is not readily available. Data can be pieced together from various sources, but this can be a confusing exercise because of the different types of non-conforming loans (Alt-A and subprime) and the different channels through which the GSEs purchase these loans (through securitizations and through their ''flow-based'' product offerings). Freddie Mac, which has been the more aggressive GSE in the subprime market, purchased approximately $12 billion in subprime loans during 1999—$7 billion of A-minus and alternative-A loans through its standard flow programs and $5 billion through structured transactions.[175] In 2000, Freddie Mac purchased $18.6 billion of subprime loans on a flow basis in addition to another $7.7 billion of subprime loans through structured transactions.[176] Freddie Mac securitized $9 billion in subprime and Alt-A product in 2001 and $11.1 billion in 2002.

Fannie Mae initiated its Timely Payments product in September 1999, under which borrowers with slightly damaged credit can qualify for a mortgage with a higher interest rate than prime borrowers. Under this product, a borrower's interest rate will be reduced by 100 basis points if the borrower makes 24 consecutive monthly payments without a delinquency. Fannie Mae has revamped its automated underwriting system (Desktop Underwriter) so loans that were traditionally referred for manual underwriting are now given four risk classifications, three of which identify potential subprime (A-minus) loans.[177] Fannie purchased about $600 million of subprime loans on a flow basis in 2000.[178] Fannie Mae securitized around $0.6 billion in subprime mortgages in 2000, before increasing to $5.0 billion in 2001 and 7.3 billion in 2002.[179]

In terms of total subprime activity (both flow and securitization activities), Fannie Mae purchased $9.2 billion in 2001 and over $15 billion in 2002, the latter figure representing about 10 percent of the market, according to Fannie Mae staff.[180]

A greater GSE role in the subprime lending market will most likely have a significant impact on the subprime market. Currently, the majority of subprime loans are not purchased by GSEs, and the numbers of lenders originating subprime loans typically do not issue a large amount of prime loans. Partly in response to higher affordable housing goals set by HUD in its new rule set in 2000, the GSEs are increasing their business in the subprime market. In the 2000 GSE Rule, HUD identified subprime borrowers as a market that can assist Fannie Mae and Freddie Mac in reaching their higher affordable housing goals while also helping establish more standardization in the subprime market. According to an Urban Institute study in 2002, many subprime lenders believe that successful companies serving high-risk borrowers need to have specialized expertise in outreach, servicing, and underwriting, which is lacking among most prime lenders.[181] These lenders do not believe the more standardized approaches of prime lenders and the GSEs will work with subprime borrowers, who require the more customized and intensive origination and loan servicing processes currently offered by experienced subprime lenders.

As noted above, both Fannie Mae and Freddie Mac make the claim that the subprime market is inefficient, pointing to evidence indicating that subprime borrowers pay interest rates, points, and fees in excess of the increased costs associated with serving riskier borrowers in the subprime market.[182] A recent Freddie Mac study found automated mortgage scoring less discriminatory and more accurate in predicting risk than manual systems such as those currently used by subprime lenders.[183] According to Fannie Mae, although a high proportion of borrowers in the subprime market could qualify for less costly prime mortgages, it remains unclear why these borrowers end up in the subprime market.[184] Fannie Mae and Freddie Mac believe they can bring more efficiency to the subprime market by creating standardized underwriting and pricing guidelines in the subprime market. An expanded GSE presence in the subprime market could be of significant benefit to lower-income and minority families if it attracted more mainstream lenders and competition to those inner-city neighborhoods that are currently served mainly by subprime lenders.

Many subprime lenders do not think it is appropriate for Fannie Mae and Freddie Mac to increase their role in the subprime market because they do not view the subprime market as inefficient. Some officials in subprime mortgage markets claim the higher prices paid by borrowers in the subprime market appropriately reflect the risks that come from extending credit to riskier borrowers. These officials believe it is unfair for GSEs to enter an efficient, private market that provides a necessary service to credit-impaired borrowers. Opponents of a larger GSE role in the subprime market argue GSEs have an unfair competitive advantage because they can secure capital at cheaper rates.[185] Because the GSEs have a funding advantage over other market participants, they have the ability to under price their competitors and increase their market share.[186] This advantage, as has been the case in the prime market, could allow the GSEs to eventually play a significant role in the subprime market. Many subprime lenders fear they will be unfairly driven out of business as the GSEs increase their role in the subprime market.

9. Risk-Based Pricing

The expanded use of automated underwriting and the initial uses of risk-based pricing are changing the mortgage lending environment, often blurring the distinctions between the prime and subprime market. Prime lenders are now using automated underwriting systems that are being adapted to facilitate risk-based pricing. For some time, the majority of prime mortgage borrowers have received loan rates based on average cost pricing. Generally, borrowers receive roughly the same Annual Percentage Rate[187] (APR), regardless of the risk of loss to the lender. The risk of all borrowers is averaged together, and the price is determined by the average risk.

In contrast, risk-based pricing enables mortgage lenders to offer each borrower an individualized interest rate based on his or her risk. Or, more broadly, to offer interest rates based on whether or not the borrower

[174] Temkin et al., 2002, p. 1.

[175] David A. Andrukonis, ''Entering the Subprime Arena,'' *Mortgage Banking*, May 2000, pp. 57–60.

[176] Subprime Lenders Mixed on Issue of GSE Mission Creep,'' Inside B and C Lending, March 19, 2001.

[177] See Lederman, et al., *Op cit.*

[178] Kenneth Temkin, Jennifer E. H. Johnson, and Diane K. Levy, ''Subprime Markets, the Role of GSEs, and Risk-Based Pricing,'' *Urban Institute*, August 2001, p. 1.

[179] *Inside Mortgage Finance's*, ''Inside MBS & ABS,'' December 15, 2000 and March 8, 2002.

[180] Statement by Mercy Jimenez of Fannie Mae in ''Fannie Mae: Forges Ahead in Subprime,'' *Secondary Marketing Executive*, February 2003, p.15.

[181] Temkin *et al.*, 2002, p. 1

[182] See Lax *et al.*, 2000.

[183] Zorn, *et al.*, 2001, p. 5.

[184] Fannie Mae, Remarks Prepared for Delivery by Franklin Raines, Chairman and CEO of Fannie Mae to the National Community Reinvestment Coalition. Washington, DC, March 20, 2000.

[185] Temkin *et al.*, 2002, p. 1.

[186] For an explanation of the GSEs funding advantage see *Government Sponsorship of FNMA and FHLMC*, United States Department of the Treasury, July 11, 1996.

[187] Annual Percentage Rate takes into account points, fees, and the periodic interest rate.

falls into a certain category of risk, such as specific loan-to-value and FICO score combination or specified mortgage score range. Lenders could also set the interest rate based on various factors including the probability of prepayment and characteristics of the underlying collateral, as well as the default risk of the borrower. Borrowers that pose a lower risk of loss to the lender would then be charged a comparatively lower rate than those borrowers with greater risk. Rather than lower risk borrowers cross-subsidizing higher risk borrowers like in average cost pricing, lower risk borrowers pay a relatively lower rate.

In response to the expanded use of automated underwriting and pressures from the GSEs, other purchasers of loans, mortgage insurers, and rating firms, lenders are increasing their use of risk-based pricing.[188] In today's markets, some form of differential pricing exists for the various subprime categories, for new products targeted at credit-impaired borrowers (such as Fannie Mae's Timely Payments product), and for private mortgage insurance across all credit ranges. For example, private mortgage insurers use FICO scores and ''Accept'' determinations from the GSEs'' automated underwriting systems to make adjustments to insurance premiums.[189] Rating agencies vary subordination requirements based on the credit qualify of the underlying collateral.

Many believe there is cross-subsidization within the crude risk categories used in today's market. For example, some of the better quality subprime borrowers in the A-minus category may be inappropriately assigned to the subprime market. The GSEs and others are attempting to learn more about the subprime market, and their initial efforts suggest that there will be an increase in the use of risk-based pricing within this market, although it is recognized that the expansion of risk-based pricing depends importantly on these parties gaining a better understanding of the subprime borrower and the ability of their mortgage scoring systems to predict risk within this market. It must be noted that the power of the underlying algorithm in automated underwriting systems determines the ability of these systems to accurately predict risk and set prices.

If prime lenders adopted risk-based pricing, many would be willing to lend to riskier subprime borrowers because their risk would now be offset with an increase in price. In theory, the mortgage market should expand because all mortgages will be approved at a price commensurate with risk, rather than setting a risk floor and approving no one beneath the floor. Risk-based pricing could also expand the prime lenders' market by enabling them to reach a new group of underserved customers.[190] Taking advantage of GSEs' lower cost of capital, GSEs may be able to offer borrowers who could not afford a rate in the subprime market a rate they can afford resulting from risk-based pricing.

Risk-based pricing also poses challenges on the mortgage market because some of the more risky borrowers (who are currently cross-subsidized by less risky borrowers) may not be able to afford their higher, risk-based interest rate. Also, the adoption of an automated risk-based pricing system may have an uncertain effect on minority groups, who tend to have lower credit scores, as discussed earlier. On the other hand, if minorities are eligible for prime financing, the cost of financing minorities may fall as will the potential for subprime lenders to draw minorities to their higher-priced products.

As the GSEs become more comfortable with subprime lending, the line between what today is considered a subprime loan versus a prime loan will likely deteriorate, making expansion by the GSEs look more like an increase in the prime market. This melding of markets could occur even if many of the underlying characteristics of subprime borrowers and the market's evaluation of the risks posed by these borrowers remain unchanged. Increased involvement by the GSEs in the subprime market will result in more standardized underwriting guidelines and the increased participation of traditional lenders. In fact, there are indications that mainstream players are already increasing their activity in this market. According to staff from Moody's Investors Service, the growing role of large mortgage aggregators in the subprime market has been a key factor in the improving credit qualify on deals issued in 2002.[191] According to a representative from Washington Mutual, subprime credit qualify has also improved as lenders carve out new loan categories that fall somewhere between the large Alt A market and traditional subprime business.[192] As the subprime market becomes more standardized, market efficiencies will reduce borrowing costs. Lending to credit-impaired borrowers will, in turn, increasingly make good business sense for the mortgage market.

C. Factor 2: Economic, Housing, and Demographic Conditions: Multifamily Mortgage Market

1. Introduction

At the time of the previous GSE rulemaking in 2000, the multifamily rental housing market was coming off several years of generally positive performance. Vacancies were low in most markets and rent increases were matching or exceeding economy-wide inflation. A key to this strong performance was the volume of new multifamily construction, which was at a level consistent with demand growth. Job growth and income gains helped many renters pay the higher rents without undue burden. As always, conditions varied from region to region, and across market segments, but the overall tone of the apartment market was quite healthy.

Much has changed in the subsequent three years. The economic slowdown has reduced apartment demand, and with new multifamily construction about unchanged, vacancies have risen and rents have softened. Provision of decent housing affordable to households of moderate or low incomes is a challenge even in strong economic times, and with the unemployment rate up nearly two percentage points since late 2000, affordability problems have increased for many, despite the softness in rents.

Despite the recent weakness in the apartment property market, the market for financing of apartments has grown to record volumes. The favorable long-term prospects for apartment investments, combined with record low interest rates, has kept investor demand for apartments strong and supported property prices. Refinancings too have grown, and credit quality has remained very high. Fannie Mae and Freddie Mac have been among those boosting volumes and introducing new programs to serve the multifamily market.

This section will review these market developments, interpret the performance of Fannie and Freddie within that market context, and discuss future prospects for the multifamily rental market, its financing, and the GSE role. The intention here is only to update the discussion from 2000. For general background information on the multifamily mortgage market and the GSEs, see the 2000 Rule and the HUD-sponsored research report, *Study of Multifamily Underwriting and the GSEs' Role in the Multifamily Market* (Abt Associates, 2001).

2. The Multifamily Rental Housing Market: 2000–2003

The definition of ''good'' market conditions in multifamily rental housing depends on one's perspective. Investors and lenders like low vacancies, steady rent increases, and rising property values. Developers like strong demand for new construction and favorable terms on construction financing. Consumers, in contrast, prefer low rents and a wide selection of available apartments.

The mid- to late-1990s were among the most successful of recent history, in that apartment market conditions were generally good for all of these interest groups. Investment returns were favorable, construction volumes were steady at sustainable levels, and many consumers had income gains in excess of their rent increases.

Market conditions for multifamily rental housing began to weaken toward the end of 2000. Early warnings came from the publicly traded apartment companies, some of which reported easing in demand growth in the first months of 2001, coinciding with a slowdown in job growth to its lowest level since 1992.

By the second quarter of 2001, most apartment market indicators were reflecting the slowdown. Vacancies were up, approaching 10 percent for all multifamily (5+ units in structure) rental housing, according to the Census Bureau, and about half that rate among the larger apartment properties monitored by private market research firms. The FDIC's *Survey of Real Estate Trends* detected the first signs of weakening in the first half of 2001, followed by a big falloff in second half of the year and a continuing slide in the first half of 2002.

Apartments—especially those serving the top end of the rental market—appear to have

[188] Temkin *et al.*, 2002, p. 29.

[189] For example, see Radian's product offerings at *http://www.radiangroupinc.com*.

[190] Vanessa Bush, ''Risk-Based Pricing Trend Could Make Mortgage Lending More Efficient,'' *America's Community Banker*, October 1, 1998.

[191] ''Improving Credit Quality, Maturing Business Stoke Confidence in Subprime MBS Market,'' *Inside MBS & ABS*, published by Inside Mortgage Finance, February 21, 2003.

[192] *Ibid.*

performed worse than other rental housing in the past four years, after several years of rent growth and occupancies surpassing the rental market averages. The multifamily vacancy rate has increased more than the overall rental market vacancy rate in each of the years 2000, 2002, and 2003. In 2001, the vacancy rates increased at an equivalent rate. For example, the Census Bureau's estimate of a 1.2 percentage point increase in vacancies for apartments in the year ending in the third quarter of 2003 exceeds the overall rental vacancy rate of .9%. Similarly, while rent growth has decelerated slightly for all rental housing according to the CPI, industry surveys of apartment rents show year-over-year declines in rents in many local markets.[193] In 2003, asking rents remained flat nationally, as multifamily completions declined 5 percent.[194]

a. Apartment Demand and Supply

The primary reason for the softening in the multifamily rental market has been a reduction in the growth of consumer demand for apartment housing. The general slowdown in economic activity meant fewer apartment customers, with less money, than if the economy were vigorously expanding. Persistent low interest rates have also enticed renters into the home purchase market as evidenced by the U.S. homeownership rate, which grew to 68.4 percent in 2003, further contributing to a weakness in rental demand.

The reduced demand is most evident in the national statistics on employment. Job growth began decelerating in late 2000 and throughout 2001, turning negative late that year. The largest year-over-year job loss of the economic downturn occurred in February 2002, and year-over-year losses have continued through October 2003. Apartment demand seems particularly sensitive to labor market conditions, given the importance of rental housing to mobile individuals and families accepting new jobs or transfers. Reis, Inc., a real estate market research firm, estimates that the total number of occupied apartments (in properties with 40+ units) actually declined in both 2001 and 2002 in the large markets nationwide that are monitored by the company.[195]

Households, not jobs, fill apartments, and for this reason household formations are a preferable indicator of demand for apartments as well as other types of housing. The Census Bureau estimates that the total number of renter households nationwide has been essentially unchanged at approximately 34.8 million since 1996. Yet during the late 1990s apartment demand was expanding, and apartments were apparently picking up market share from other rental housing. The past two or three years may have seen a reversal of that trend in share.

Long-term demographic trends are expected to be favorable for rental housing demand.[196] The maturing of the ''Baby Boom Echo'' generation will increase the number of persons under age 25 who will seek rental housing, immigration is expected to continue to fuel demand for rental housing, and minority populations, while increasing their homeownership rates, are growing and will contribute to higher absolute demand for rental housing. Thus demographic trends support an improvement in the long-run demand for rental demand, which is likely to include higher multifamily rental demand.

Supply growth has been maintained, even though the current reduced multifamily demand warrants less new construction. Total multifamily starts (2+ units) have been running approximately 325-to-350 thousand annually for the past six years, according to Census Bureau statistics, adding about 1 percent annually to the total multifamily stock. Most of these new units are built for rental use, with only about 20 percent in recent years reported as being built as for-sale condominium units.

The reduced short-term demand has shown through in absorption speeds for new apartments. The percentage of newly completed unfurnished apartments rented within three months of completion fell from 71 percent during the first quarter of 2000 to 64 percent during the first quarter of 2001 and to 58 percent during the first quarter of 2002, according to the Census Bureau. This percentage rose slightly to 59 percent in the first quarter of 2003.

b. Performance by Market Segments

Some segments of the multifamily rental market have been more affected than others by the recent softening. As mentioned earlier, the top end of the apartment market seems especially hard hit, as measured by rising vacancies and reduced rent growth. This segment is particularly dependent on job growth and transfers for new customers, and is particularly vulnerable to losses of residents and prospective customers to home purchase. According to reports by apartment REITs and other investors, these top-end properties have not been getting the job-related in-movers, but have still been losing a lot of customers to home purchase. These properties generally have annual resident turnover rates of above 50 percent, and thus are particularly quickly influenced by changes in demand. Furthermore, this is the segment of the apartment market into which most of the new construction is built.

Performance has varied geographically as well. Some of the coastal markets, especially in Northern California, saw the double-digit rent increases of the late 1990s replaced by double-digit declines, before stabilizing more recently. ''Supply constrained markets'' had been preferred by apartment investors during the 1990s, but recent market performance has reminded investors and analysts that all markets have their day. For example, Houston posted the biggest year-over-year rent increase of any major apartment market in 2001, despite a long-run history of moderate rent growth and few barriers to new apartment construction. Rent changes in the 27 metropolitan markets for which estimates are available from the CPI ranged from a low of −0.3 percent to a high of 6.7 percent in the first half of 2003 relative to a year earlier. And across the 75 metropolitan areas for which rental vacancy rates (apartments plus other rentals combined) are available, rates for the year 2002 ranged from 2.4 percent to 15.4 percent, according to the Census Bureau. In a historical context, this variation is moderate, although up somewhat since the late 1990s.

Conditions in the ''affordable'' segment of the apartment market are harder to track than in the high-end segment because of lesser investor interest and analyst coverage. Data for the late 1990s analyzed by the National Housing Conference saw affordability problems continuing, although a study of apartment renters by the National Multi Housing Council saw some improvement in affordability during the strong economic growth of 1997–1999.[197] Other work noted that rent to income ratios for the lowest income quintile of renters rose during the late 1990s even as these ratios were stable or declining for other renters.[198] Harvard's *State of the Nation's Housing* report for 2002 highlighted the variability of the affordability problem from place to place.[199]

Little research is available on affordability trends since 1999. However, tabulations from the 2001 *American Housing Survey* indicate that income growth between 1999 and 2001 in the lowest quintile of renter households continued to lag that of higher income renters, and fell short of the average rent increases during this period. Together, these statistics suggest that affordability has deteriorated early this decade among at least this group of very low-income renters. Other work using the AHS found that the number of low-to moderate-income working families with severe rental cost burdens increased 24 percent between 1999 and 2001.[200]

The low-income housing tax credit (LIHTC) continues to finance much of the newly built multifamily rental housing that is affordable to households with moderate income. Restricted to households with incomes no greater than 60 percent of the local median, this program financed approximately 75,000 units in 2001, according to the National Council of State Housing Agencies, after running in the mid- to high-60 thousand range the previous three years. About 70 percent of these units are newly built, and the rest are renovations of existing units.

Expenditures for improvements to existing rental apartments have grown in recent years.

[193] *See,* for example, Marcus & Millichap Research Services, *National Apartment Report,* January 2003.

[194] Marcus & Millichap Research Services, *National Apartment Report,* January 2004.

[195] ''Apartment Landlords Gather to Dreary Outlook for Sector,'' *Wall Street Journal,* January 15, 2003, Section B.

[196] Mortgage Bankers Association of America, ''MBA News Link: Rental Market Demographics ''Favorable,'' Report Says,'' January 2003.

[197] Center for Housing Policy/National Housing Conference, ''Housing America's Working Families: A Further Exploration,'' *New Century Housing,* Vol. 3, No. 1, March 2002; Mark Obrinsky and Jill Meron, ''Housing Affordability: The Apartment Universe,'' *National Multi Housing Council,* 2002.

[198] ''Housing Affordability in the United States: Trends, Interpretations, and Outlook,'' a report prepared for the Millennial Housing Commission by J. Goodman, November, 2001.

[199] Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing, 2002.*

[200] Center for Housing Policy/National Housing Conference, ''America's Working Families and the Housing Landscape 1997–2001,'' *New Century Housing,* Vol. 3, No. 2, November 2002.

In 2001 the total of $11.3 billion was nearly twice the figure of three years earlier, according to the Census Bureau, and more than a third as large as construction spending for newly built multifamily structures, including owner-occupied condos. Many of these improvements are to older properties in high-demand neighborhoods. Improvements to the physical structures have external benefits. But often the renovations are in connection with re-positionings that move the apartments into a higher rent range and bring changes in the demographic composition of the resident base.

In 2002, expenditures on total improvements to existing apartments declined to $9.8 billion, while new construction spending increased $2 billion. This shift further suggests a re-positioning to apartments with a higher rent range. Excluding units financed with tax credits or other subsidies, most of the multifamily rental construction in recent years has been targeted on the upper end of the market, often the only segment for which unsubsidized new construction is economically feasible. The median asking rent on new unfurnished apartments completed in 2001 was $877, up 11 percent over the previous two years. In 2002 median asking rent for these properties was $905. Of those units brought to market in 2002, 45 percent were at rents at or above $950.

3. Multifamily Financing Trends

In contrast to the softening observed in the demand/supply balance for multifamily, mortgage financing of these properties has been at a record pace in the past three years.

a. Lending Volume

Total multifamily mortgage debt outstanding increased 9.5 percent in 2000 (Q4/Q4), 11.4 percent in 2001, and 8.6 percent in 2002, according to the Federal Reserve's Flow of funds accounts. This trend continued through the third quarter of 2003, which saw a 12.4 percent annualized increase. The dollar volumes were above those of any previous year, and far exceeded the lending volumes of all years other than 1998 and the frenzied period 1985–86. The pace has picked up slightly in 2003, with figures through the first two quarters indicating annualized growth of about 9 percent. Furthermore, a survey by the Mortgage Bankers Association of America shows that of 48 member firms surveyed, representing all large mortgage banking firms and a cross section of smaller mortgage companies, multifamily origination volume increased by 16 percent in 2002—from $35 billion in 2001 to $41 billion in 2002.

The apparent inconsistency between current market fundamentals and financing can be explained by low interest rates. The same financial forces that lowered the mortgage rates for home purchasers to record lows by 2002 also reduced the financing costs of multifamily properties. The ten year Treasury yield, a common benchmark for multifamily loan pricing, fell to a 45-year low of 3.3 percent in June 2003 from 6.3 percent as recently as the end of 1999.

Another feature boosting investor demand for apartment properties and the resulting demand for debt to finance those purchases has been the lack of attractive returns on many financial assets and other alternative investments. Despite the current weak performance of apartments, investors apparently are looking through to the long-run outlook for these assets, which is generally thought to be favorable, as indicated most recently by investor surveys fielded by the Urban Land Institute and by LendLease and PriceWaterhouseCoopers.[201]

The net change in mortgage debt outstanding is defined as loan originations less repayments and charge offs. As discussed in Appendix D, net change is a lower bound on originations. By all accounts, originations—for which no single source of estimates is available—are much higher than net change in most years. High levels of refinancings of existing multifamily mortgages in recent years has been a factor in originations exceeding the net change in debt outstanding.

Most mortgage lending is in the "conventional" market. Multifamily loan programs of the Federal Housing Administration accounted about $7 billion in new insured mortgages in fiscal year 2003—up from $6 billion in fiscal year 2002 and $5 billion in fiscal 2001. Despite the recent increase in FHA originations, and the likely continued strong performance for FHA multifamily programs in the foreseeable future,[202] FHA remains but a small portion of the total multifamily mortgage market. Outstanding FHA-insured multifamily mortgage debt was $55 billion at the end of the first quarter of 2003—only about 11 percent of all multifamily mortgage debt outstanding.

Multifamily lending has been spurred by new apartment construction, property sales, and refinancings. New multifamily construction was valued at $32.6 billion in 2002, according to the Census Bureau, up 14 percent from 2000. The number of new multifamily units completed over this period actually declined 6 percent, and the increased expenditures reflect higher costs per unit. The increase in asking rents described earlier suggests higher property values and greater debt carrying capacity.

b. Property Sales and Refinancings

Sales of existing apartment properties tend to be pro-cyclical. Increasing asset values bring buyers to the market and tempt sellers to realize their capital gains. In soft markets, in contrast, the bid-ask spread generally widens and the volume of sales declines, as sellers perceive current offers as beneath the property's long run value and buyers are reluctant to pay for past performance or the hope of future gains. Sales tend to increase mortgage debt, because the loan originated to finance the purchaser's acquisition is typically considerably larger than the mortgage retired by the seller.

No source of apartment property sales statistics matches the comprehensive national coverage of the single-family market provided by the National Association of Realtors' monthly estimates. But surveys by the National Multi Housing Council and other apartment industry reports indicate that transactions volume dipped during 2001 and has since stabilized but not yet returned to the levels of the late 1990s. Even if the number of transactions is off, the dollar volume may well have risen, depending on the mix and prices of properties sold.

Mortgage lending volumes have recently been boosted by shifts in property ownership. Publicly traded real estate investment trusts had been the big gainers during most of the 1990s, and by 1999 owned nearly 6 percent of all apartments nationwide and a considerably larger share of all big (100+ unit) properties. But beginning in 1999 capital market developments made private buyers more competitive. Since then the number of apartments owned by large REITs has declined about 5 percent, with diverse private interests apparently picking up market share.

Private investors are able to use more leverage—greater debt—in financing their transactions than the market permits the public REITs. As a result, the very low mortgage rates recently have given them an advantage in bidding on properties. In addition, equity funding costs of REITs rose as their stock prices flattened or moved down as part of the broader equity market correction.

Refinancings have, by all accounts, also been strong. Despite the lockout provisions and yield maintenance agreements that constrain early refinancings of many multifamily loans, lenders reported very strong refinancing activity in 2001 and continuing into 2002. Although refinancing volume data for the entire market are not available, the trends in refinance volume for FHA and the GSEs show very strong increases in refinance activity during 2002 and 2003. For example, FHA's Section 223(a)(7) program, which is limited to refinancing of FHA multifamily mortgages, experienced an increase in origination volume of 133 percent in Fiscal Year 2003 and 181 percent in Fiscal Year 2002. ($1.73 billion in FY 2003, $0.74 billion in FY 2002, and $0.26 billion in FY 2001). Similarly, the GSEs increased their combined volume of refinances by 83 percent from 1999–2000 to 2001–2002, from $17.6 billion to $32.1 billion. Refinancings, especially when motivated by a desire to lower interest expense rather than to extract equity, do not add as much to debt outstanding as do purchase loans, which often are much larger than the seller's existing mortgage that is repaid at the time of sale. Nonetheless, refinancings represent a significant part of all multifamily mortgage lending.

c. Sources of Financing and Credit Quality

The sources of funding of multifamily mortgages shifted somewhat in the past few years, judging from the Flow of Funds accounts. As shown in Table A.4, four categories of lenders have dominated multifamily mortgage lending since the mid-1990s. Of those four, commercial banks have played a lesser, although still substantial, role in recent years, providing 20 percent of the $86 billion in net additional funding of multifamily mortgages during 2000 and 2001.

[201] Urban Land Institute, *The ULI Forecast, 2002;* Lendlease and Prive WaterhouseCoopers, *Emerging Trends in Real Estate, 2003.*

[202] Merrill Lynch, *A New Look at FHA Prepayments and Defaults,* September 2002.

The portfolio holdings of the GSEs, by contrast, have been much more important than during the last half of the 1990s. Mortgage backed securities, both from the GSEs and especially from other issuers, accounted for proportionally less of the growth in 2000–01 than in 1995–99, but between them still accounted for nearly half of all the net credit extensions. Some slight broadening of the base of multifamily lending in the past two years, as these four lender groups accounted for only 85 percent of the net credit extended in 2000 and 2001, compared to all of it in the previous five-year period.

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Table A.4

Providers of Net Additions to Multifamily Mortgage Debt Outstanding

(Percent distribution)

	2000-2001	1995-1999
Commercial Banks	20 %	27 %
Fannie Mae/ Freddie Mac		
Portfolio	15	2
MBS	18	25
Private MBS	17	32
All Others	30	14
Total	100 %	100 %
Memo: Aggregate Net Addition to Debt ($ billions)	85.5	93.9

Sources: Federal Reserve Flow of Funds Accounts, OFHEO 2001 Annual Report.

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